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KATHLEEN CONNELL
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Member

May 3, 2002

Chief Counsel Ruling
201374

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Re: **********

Dear **********:

This Chief Counsel Ruling is issued in response to your October 26, 2001, request on behalf of your client, **********. The request is for ******* *****, an attorney-in-fact, to be able to liquidate on a tax-free basis, pursuant to Internal Revenue Code section 332 and conforming provisions of the Revenue and Taxation Code, two of its wholly owned subsidiaries that act as attorneys-in-fact for two insurance exchanges.

FACTS

**********, a Nevada corporation, is the parent of an affiliated group of companies that include wholly owned subsidiaries, ********** ********** and **********, both of which are California corporations. ********** principal business activity is the provision of management services to ********** **********. ********** is the attorney-in-fact for ********** ********** is the attorney-in-fact for the ********** is the attorney-in-fact for the **********.

The Exchanges are unincorporated associations domiciled in California and are registered with the California Department of Insurance as property and casualty insurance companies. The Exchanges file federal tax returns as if they were corporations under Internal Revenue Code section 7701 and Treasury Regulations section 3301.7701-3. Even though the California Code of Regulations, title 18, section 23038(b)-3(c)(1) requires the Exchanges to be classified as corporations consistent with federal treatment, the Exchanges do not file California franchise and income tax returns because, under California law, the Exchanges are subject to the gross premiums tax on their insurance business.

The Exchanges are owned by the policyholders who insure one another on a reciprocal basis and are considered to be inter-insurance or reciprocal exchanges. The

participants function as both insurer and insured by exchanging insurance contracts with one another. The contracts are exchanged in order to minimize the financial hazards an individual insurer must bear with respect to a specific insurance contract. The insurance exchange is predominantly a mechanism to facilitate the spreading of risk among insurers.

An exchange will conduct business through an attorney-in-fact. An attorney-in-fact is empowered to exchange insurance contracts on behalf of its participants. The participants deposit premiums with the exchange. In order to be formally designated as an attorney-in-fact, a corporation must satisfy certain statutorily mandated requirements. The attorneys-in-fact are treated as a single entity with their respective insurance exchange and are subject to gross premiums tax with respect to their income derived from their principal business as attorney-in-fact. In addition, the attorneys-in-fact file California franchise tax returns to report their non-attorney-in-fact income and to pay annual franchise tax of at least the required minimum franchise tax amount.

The reciprocal exchange concept and its relationship to the attorney-in-fact were described in *Delos* v. *Farmers Group, Inc.* (1979) 93 Cal.App.3rd 642, at 651-652.

> At trial, Parke Godwin, a vice president of the Group, explained the relationship between an inter-insurance exchange and its attorney-in-fact. As an inter-insurance or reciprocal exchange, the Exchange consists of its policyholders who insure one another. He said: "[If] it were small enough, they [the policyholders] would just get together from time to time and put money in a big barrel and take the money out of the big barrel for claims purposes. Since it is three and a half, four million people, it is not practical. A management company or an attorney-in-fact is appointed to handle all of those monetary and other affairs to see that the property is properly accepted and property disbursed and properly accounted for." In order to effectuate this relationship, every policyholder of the Exchange was required to appoint the Group as attorney-in-fact.
>
> The relationship between an inter-insurance exchange and its attorney-in-fact was more formally described in *Industrial Indem. Co.* v. *Golden State Co*. (1953) 117 Cal.App.2d 519, 522-523 [256 P.2nd 677]: "A reciprocal insurance exchange, regulated in sections 1280-1530 of the Insurance Code, is an unincorporated business organization of a special character in which the participants, called subscribers (or underwriters) are both insurers and insureds; for their mutual protection, they exchange insurance contracts through the medium of an attorney-in-fact, empowered in each underwriters agreement

> not only to exchange insurance contracts for the subscribers, but also to exercise *all* other functions of an insurer, e.g., to set rates, to settle losses, to compromise claims, to cancel contracts. The subscribers furnish by their premium deposits, the means required for losses and costs, reserves and surpluses of the reciprocal insurance of them all, and therefore are entitled to the equity in the assets of the Exchange subject to the purpose for which they have furnished said means. If the amount of premiums deposited is not fully required for the purposes mentioned, the excess, called savings, is returned in whole or in part as dividends. The attorney-in-fact receives a sizable percentage of the premiums deposited in consideration of which he does not only provide his own services, but also has to defray many of the costs of the businesses." (Italics supplied.)
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> In summary, for legitimate business considerations, the Group was formed to render management services for the Exchange for which it received a percentage of premiums paid by the Exchange's policyholders.

Each policyholder of the Exchanges appoints ********** as the exclusive attorney-in-fact. The rights and obligations of the attorneys-in-fact are set forth in a subscription agreement which is signed by every policyholder at the time of application for insurance. The attorneys-in-fact provide management services to the non-claims side of the business. These management services include selecting risks, preparing and mailing policy forms and invoices, collecting premiums and performing certain other administrative and managerial functions. The attorneys-in-fact are contractually permitted to receive a management fee based on the gross premiums earned by the Exchanges for managing the business of the exchange and to defray the costs of operating the Exchanges. (See *Industrial Indemnity Co*. v. *Golden State Co.* (1953) 117 Cal.App.2d 519, 522-523.) The Exchanges are responsible for their own claims functions, including the settlement and payment of claims and claims adjustment expenses. They are also responsible for the payment of commissions and bonuses for agents and district managers, and their own premium and income taxes.

********** is considering liquidating ********** in an effort to improve the overall performance of the three attorneys-in-fact. To this end, in accordance with Internal Revenue Code section 332(b), ********** will formally adopt a plan of liquidation for ********** indicating the period within which the liquidation will be completed and file a federal Form 966 within thirty days of adopting the plan. ********** will distribute all of the assets and liabilities of ********** to ********** in complete liquidation and cancellation of their outstanding common stock and will file a tax return reporting the information required by the applicable Treasury Regulations. ********** may set up

two new Nevada or Delaware corporations that will be used solely to hold the name of **********.

Under the plan of liquidation, while the structure of the organization would change, its substance would remain the same. Currently, **********, although separate legal entities, function as a single business unit. These separate entities utilize the same management team, accounting, actuarial, auditing, office facilities, human resources, information technology, legal, marketing, policy processing and underwriting functions. Certain aspects of all of these functions must be done in triplicate to satisfy the legal and fiduciary responsibilities of an attorney-in-fact. It is ********** desire to combine these entities into a single attorney-in-fact and have its legal structure mirror its operational structure. The policyholders that own ********** as their attorney-in-fact and the Exchanges will continue to operate as they presently do.

ISSUE

Whether the gain on the liquidation of **********, which is nontaxable for federal income tax purposes under Internal Revenue Code section 332, will likewise be nontaxable under California law.

HOLDING

The portion of the liquidation gain attributable to assets that produce attorney-in-fact income, or are used in the attorney-in-fact activities, will be exempt pursuant to the California Constitution. The portion of the gain that is attributable to assets that produce non-attorney-in-fact income, or are used in non-attorney-in-fact activities, will be subject to the provisions of Internal Revenue Code section 332, as conformed to in the California Corporation Tax Law.

LAW AND ANALYSIS

Subdivision (a) of section 28 of Article XIII of the California Constitution defines an "Insurer" to include "insurance companies or associations and reciprocal or interinsurance exchanges together with their corporate or other attorneys in fact considered as a single unit, and the State Compensation Insurance Fund." "Companies" is defined in that subdivision to include "persons, partnerships, joint stock associations, companies and corporations."

Subdivision (b) of section 28 of Article XIII of the California Constitution imposes an annual tax on each insurer doing business in this state. Subdivision (c) states that the basis of the amount of tax is "the amount of gross premiums, less return premiums, received in such year by such insurer upon its business done in this state. . . ."

Subdivision (f) of section 28 of Article XIII of the California Constitution states:

> The tax imposed on insurers by this section is in lieu of all other taxes and licenses, state, county, and municipal, upon such insurers and their property, except: . . .
>
> (6) That each corporate or other attorney in fact of a reciprocal or interinsurance exchange shall be subject to all taxes imposed upon corporations or others doing business in the State, other than taxes on income derived from its principal business as attorney in fact.
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> A corporate or other attorney in fact of each exchange shall annually compute the amount of tax that would be payable by it under the prevailing law except for the provisions of this section, and any management fee due from each exchange to its corporate or other attorney in fact shall be reduced pro tanto by a sum equivalent to the amount so computed.

Consistent with the California Constitution, section 1530 of the Insurance Code generally provides that attorney-in-fact income is exempt from California corporate franchise tax. This exemption, however, applies only to the attorney-in-fact income. Section 1530 states:

> In lieu of all other taxes, licenses or fees whatever, state or local, each exchange and its corporate attorney in fact considered as a single unit shall together pay annually on account of the transaction of such business in this state, the same fees as are paid by mutual insurers transacting the same kind of business, and the annual tax imposed by Section 28 of Article XIII of the Constitution of the State of California and by the applicable provisions of the Revenue and Taxation Code, except that each corporate attorney in fact of a reciprocal or interinsurance exchange shall be subject to all taxes imposed upon other corporations doing business in the state, other than taxes directly attributable to property used exclusively in or on income derived from its principal business as corporate attorney in fact. In any event, such corporate attorney in fact shall file an annual return and pay the minimum tax provided for by Section 23151 of the Bank and Corporation Tax Law.

Revenue and Taxation Code section 12003 defines "insurer" to include "[r]eciprocal or interinsurance exchanges, together with their corporate or other attorneys in fact considered as a single unit."

For California tax purposes, each attorney-in-fact is treated as a single unit with its insurance exchange and the unit pays a tax on the amount of its gross premiums in the

same manner as do stock and mutual insurance companies. The attorneys-in-fact are also subject to the California Corporation Tax Law and pay either the minimum franchise tax or a tax measured solely by noninsurance (nonexempt) income.

FTB Legal Ruling 385 (issued April 1, 1975) requires the exclusion of an insurer's income and formula factors from its unitary group's combined report. An attorney-in-fact corporation can be a member of a unitary group, but its income and formula factors related to the exempt insurance activity are excluded from the combined report.

Revenue and Taxation Code section 23037 defines "taxpayer" to mean "any person subject to the tax imposed under Chapter 2 (commencing with Section 23101), Chapter 2.5 (commencing with Section 23400), or Chapter 3 (commencing with Section 23051)." FUA and TUA are taxpayers within the meaning of this section.

Revenue and Taxation Code section 23038 defines corporation to include "every corporation except corporations expressly exempt from tax by this part or the constitution of this state." The constitution expressly exempts from franchise and income tax "insurers" by specifying the manner in which the insurer is to be taxed (a gross premiums tax) and stating that the tax is in lieu of all other taxes, with certain exceptions. The constitution defines "insurer" to include interinsurance exchanges, together with their corporate attorneys-in-fact, but only with respect to "income derived from its principal business as attorney-in-fact." (Cal. Const., art. XIII, §28, subd.(f), par. (6).) The attorney-in-fact corporate entity, except for its income derived from its principal business as attorney-in-fact, is "subject to all taxes imposed upon corporations . . . doing business in this State . . .." (Cal. Const., art. XIII, §28, subd. (f), par. (6).)

Since the constitution expressly exempts insurers, insurers are not considered corporations under Revenue and Taxation Code section 23038. Interinsurance exchanges and their attorneys-in-fact are considered to be a single unit for purposes of the imposition of the gross premiums tax. The Exchanges are registered with the Department of Insurance and in fact conduct insurance activity along with their attorneys-in-fact. While the attorneys-in-fact are a separate legal entity under California corporate law, they are viewed as a single unit with their exchanges for California tax purposes, but only with respect to their principal business as attorney-in-fact. This single unit is excluded from the definition of corporation as provided for in the Revenue and Taxation Code section 23038.

The corporate attorney-in-fact entity, except for its attorney-in-fact income, however, is "subject to all taxes imposed upon corporations . . . doing business in this State . . .." (Cal. Const., art. XIII, §28, subd. (f), par.(6).) To the extent that the attorney-in-fact is subject to Corporation Tax Law, it meets the definition of Revenue and Taxation Code section 23038.[1] This portion of its business activity is not expressly exempt under the

[1] The attorney-in-fact differs from an organization exempt under Revenue and Taxation Code section 23701 because exemption under section 23701 is for the entire entity. The entity may be subject to

state Constitution, but is expressly taxed under the Corporation Tax Law pursuant to the language in Paragraph (6) of Subdivision (f) of section 28 of Article XIII of the California Constitution.

Revenue and Taxation Code section 24451 incorporates by reference Subchapter C of Chapter 1 of Subtitle A of the Internal Revenue Code, except as otherwise provided. Included within Subchapter C of Chapter 1 of Subtitle A of the Internal Revenue Code is section 332 pertaining to corporate liquidations. Internal Revenue Code section 332 states that "[n]o gain or loss shall be recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation."

Because ********** fail to meet the definition of a corporation as provided in Revenue and Taxation Code section 23038 with respect to their attorney-in-fact income, they cannot utilize the provisions of Internal Revenue Code section 332 and the conforming California Revenue and Taxation Code provisions. In addition, the parent company, **********, is also an attorney-in-fact and does not meet the definition of a corporation with respect to its attorney-in-fact income. Since Internal Revenue Code section 332 allows non-income recognition to a parent corporation on the liquidation of its corporate subsidiary, the liquidation of one attorney-in-fact into another fails to meet the requirements of section 332 for California franchise and income tax purposes as attorneys-in-fact are not corporations under Revenue and Taxation Code section 23038 with respect to their attorney-in-fact income.[2] The portion of the gain on liquidation that constitutes attorney-in-fact income will be exempt, however, under the state Constitution.

With respect to the portion of the gain that is non-attorney-in-fact income, ********** ********** meet the definition of a corporation under Revenue and Taxation Code section 23038 and can use Internal Revenue Code section 332, as incorporated into California Corporation Tax Law.

The determination of which portion of the gain from the liquidation is attorney-in-fact and which portion is non-attorney-in-fact should be made based upon the assets that produced the gain. The gain attributable to assets used in the attorney-in-fact business to generate attorney-in-fact income will be attorney-in-fact income/gain exempt from corporate franchise tax under the state constitution. The gain attributable to those assets used in the non-attorney-in-fact business to generate non-attorney-in-fact

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unrelated business income tax, but the entity itself receives exemption status. The attorney-in-fact entity is a general corporation and is subject to the general rules of taxation for corporations. The constitution only carves out its income derived from its principal business as attorney-in-fact and combines it with its insurance exchange, defined under the state constitution as an insurer. An insurer is exempted under the constitution. The attorney-in-fact is considered to be an insurer only with respect to income derived from its principal activity as attorney-in-fact.

[2] This conclusion is consistent with the State Board of Equalization's denial of Internal Revenue Code section 332 benefits in the situation where the parent corporation was a tax-exempt entity. (*Appeal of C-M Ranch Co*., Cal. St. Bd. of Equal., 76-SBE-074, July 26, 1976.)

income will be non-attorney-in-fact income/gain to which Internal Revenue Code section 332 may apply.

Please be advised that the tax consequences expressed in this letter are applicable to the named taxpayer only and are based upon and limited to the facts submitted. In the event of a change in relevant statutory, judicial, or administrative law, a change in federal interpretation of federal law in cases where our ruling is based upon such interpretation, or a change in the material facts or circumstances relating to your request upon which this ruling is based, this ruling may no longer be applicable. It is your responsibility to be aware of these changes should they occur. This ruling does not determine whether the requirements of section 332 of the Internal Revenue Code have been met.

This letter is a legal ruling by the Franchise Tax Board's Chief Counsel within the meaning of Revenue and Taxation Code section 21012, subdivision (a)(1). Please attach a copy of this letter and your request to the back of the appropriate return(s) (if any) when filed or any notices or inquiries which might be issued.

Very truly yours,

Debra S. Petersen
Tax Counsel IV