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12.08.14 CHIEF COUNSEL RULING 2014-03

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*** **********
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Re: Chief Counsel Ruling Request for **********

Dear Mr. ****:

FACTS

********** *******is an unincorporated interindemnity arrangement among California **********, organized pursuant to California **********section ******. In 1977, the **********, a cooperative organized and operated under California Corporations Code section 12200 et seq., facilitated the formation of ***, an ********** arrangement, per the requirements set forth in Ins. Code section ******.

*** is **********entity in California organized and operating pursuant to **********. **** purpose is to provide its owner/member-********** (the "Members") with **********liability protection (the "Coverage") at cost. The operative statute prevents *** from operating for profit. Under the Coverage, claims against the Members are paid using the Members' funds, held in trust by ***, as well as from investment returns generated from ***** investment of those funds made pursuant to **********.

*** is treated as an insurance company for federal income tax purposes and files a federal Form 1120PC. However, *** is not considered an insurance company within the meaning of California law. By operation of **********, **********
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**********. As a result, *** is specifically exempted from general application of the California Insurance Code and is not required to conform to provisions such as capital and reserve requirements. In addition, *** is not treated as an "insurer" for California gross premiums tax purposes under Section 28, Article XIII of the California Constitution.

This interindemnity arrangement fulfills the level of ********** insurance coverage ********** are required to maintain pursuant to California law. However, the interindemnity arrangement differs economically from traditional insurance coverage, in that Members have potentially unlimited personal liability in the form of the annual Assessments they may be required to contribute to ***. By contrast, traditional insurance coverage limits the insured's liability to premiums paid and shifts the liability to the insurance company.

Operations

To fund ***, upon admission as a Member, each incoming ********** makes an initial trust deposit ("ITD") based on his or her ********** risk classification. These ITDs are held in reserve (the "Fund Corpus") to secure enforcement of the Coverage for the duration of each Member's participation in ***. This Fund Corpus is invested according to guidelines set forth in California Government Code ("Gov. Code") section 16430. Returns from the investment of the ITDs are required by statute to be used to satisfy the claims made against the Members, legal and other related expenses of the Members, and operating expenses of ***. Provided certain requirements are satisfied, the ITD is returned to a Member, with no gain or loss, upon death, retirement, or other voluntary termination of membership in ***.

To the extent that income from investment of the ITDs is anticipated to be insufficient to cover claims, annual assessments are levied on the Members prior to the start of each year of Coverage ("Assessments"). Assessments and revenue from ***** investments are used to pay ***** operating expenses and claims made against the Members throughout the year. The Assessments are held in reserve and are invested according to the similar guidelines as those imposed on the Fund Corpus.

The amount of the Assessments is determined by actuarial estimates of the Members' future claims liability, ***** anticipated operating expenses, and its investment income for the following Coverage year. The Assessments are designed and estimated for *** to break even each year – in theory, there would be no income or loss if the Assessment estimates were 100% accurate and Assessments precisely equaled the sum of operating expenses plus claims paid minus investment income. In some years, however, excess amounts of Assessments are collected and *** reflects net income for the year. This could occur, for instance, because operating expenses or claims paid are lower than anticipated. Because ***** enabling legislation precludes it from profiting from the interindemnity arrangement, to the extent there is a surplus of Assessments in any given year, it must be returned to the Members either by physical payment to the Members or by

applying it as a reduction of the following year's Assessments due from each Member. *** consistently follows the latter approach, i.e., excess Assessments in one year are taken into account in estimating the Assessments for the following year and reduce the Assessments from what would otherwise be estimated and assessed.

*** Does Not Operate For a Profit

***** enabling legislation effectively precludes it from operating for a profit. In pertinent part, **********reads:

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*** follows a consistent approach in years where the Assessments are insufficient to cover claims and expenses. For example, in November 2013, *** determined that the fiscal **** Assessments were insufficient and it would need additional Assessments for that year. It added this additional Assessment amount to the Assessment for fiscal ****, rather than issuing an interim assessment for ****. As in the case of over-assessments, the Member sees only one annual Assessment figure when the Assessment notices are sent out in early December each year for the following year.

This enabling legislation further states that: **********

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Thus, the sole purpose of ***** interindemnity arrangement, established pursuant to ******** **********, is to pool its Member ********** contributions to establish a sufficiently large pool of money to satisfy their

**********liability costs. To achieve this purpose, *** only collects contributions from its Members on an "as needed basis," in the form of Assessments, to cover actuarially determined estimated claims for the following year.

ISSUE

Whether*** is properly treated as a cooperative for California income and franchise tax purposes and thereby allowed a deduction under Revenue and Taxation Code ("RTC") section 24405 for income resulting from business activities for or with its Members.

HOLDING

*** should be treated as a cooperative and is eligible for an RTC section 24405 deduction.

DISCUSSION

I. *** is a "cooperative" or "mutual association" pursuant to RTC section 24405.

Based upon the California law discussed below, *** qualifies as a "cooperative" or "mutual association" within the meaning of RTC section 24405. Neither the term "cooperative" nor "mutual association" is defined by California statute. In a leading case interpreting RTC section 24405, *California State Automobile Ass'n. v. FTB,* (1987) 191 Cal.App.3d 1253, (hereinafter referred to as *CSAA*), the California Court of Appeal looked to Webster's dictionary to define "cooperative" as "an enterprise or organization owned by and operated for the benefit of those using its services," and noted that federal case law recognizes a mutual association as an association run for the benefit of the members rather than the association itself.

Both definitions accurately describe *** and its purpose. *** is owned by its Members and operated by a Board of Trustees, which is both composed of and chosen by ***** Members. Furthermore, *** operates solely for the benefit of its Members by paying **********claim liabilities on their behalf and does not exist to make a profit or otherwise benefit *** itself.

As in the case of ***, *CSAA* involved a taxpayer that was not expressly organized under California's cooperative corporation statutes (Corp. Code section 12200, et. seq.). The entity involved in **** possessed only three of the four characteristics of a cooperative or mutual association as determined under federal case law:

(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 members to a return of the premiums paid in excess of the amounts necessary to cover losses and expenses.

The taxpayer in *CSAA* did not satisfy the fourth prong because it did not return profits or dividends to its members except upon dissolution. The Court of Appeal in *CSAA* held that the language of RTC section 24405 broadly includes any organization operated "in whole or in part" as a cooperative or mutual association and the taxpayer would still be eligible because "its possession of three of the four characteristics of mutual or cooperative associations qualifies it as operated at least 'in part' on such a basis." Therefore, all four characteristics are not required to qualify for deductibility under RTC section 24405.

Nonetheless, *** does meet all four characteristics of a cooperative or mutual association, as discussed below.

1. *Common Equitable Ownership of the Assets by the Members.*

First, there is common equitable ownership of ***** assets by its Members, as all newly-admitted Members are subject to making an ITD to the *** Fund Corpus and all Members are entitled to a pro-rata distribution of assets in the event of dissolution of ***. Specifically, the governing terms of the ********* ********** Trust Agreement (hereinafter the "Agreement") set forth under Part 2, Section 4.A.1, require that every new Member submit to *** "within 30 days after written notification of [membership] approval…payment of the…Initial Trust Deposit to the *** Fund Corpus." The amount of the Initial Trust Deposit for each Member is determined under strict parameters set forth under Part 2, Section 2 of the Agreement, and is based on various factors including ********** ********** and the risk class associated with **********.

Also, there is a minimum contribution, i.e. the Initial Trust Deposit, required under the Introduction of the Agreement which states:

> The average contribution to the *** Fund Corpus shall continue to be not less than ********** unless the inter-indemnity arrangement is qualified to otherwise admit Members upon reaching ***** or more members and with an *** Fund Corpus of at least **********.

Furthermore, Part 2, Section 8 of the Agreement provides that, in the event of dissolution, "the Board of Trustees will promptly apply to any court of competent jurisdiction for a court- supervised dissolution and winding up of the business and

affairs of ***, with any final distribution of the *** Fund Corpus to be made pro rata to the persons verified as Members as of the date *** is dissolved." Thus, any excess funds (i.e., ***** assets) are common property of the Members.

2. *The Right of Dues-Paying Members to be Members to the Exclusion of Others and to Choose the Management*.

This second prong is also met because *** membership is exclusive to California ********** and dues-paying Members of *** are able to choose *****management.

Under **********, only California********** *****may be members of ***, to the exclusion of all others. This ********* condition of membership in *** is also set forth in Part 2, Section 4.A.1 of the Agreement. This same section of the Agreement also provides that "a ********* eligible to become a Member is not a Member…unless he or she has returned to *** within 30 days after written notification of approval for the membership, all of the items in Part 2, Section 4.A.1.b and Section 4.A.1.c" which includes "his or her payment of the…Initial Trust Deposit to the *** Fund Corpus." Additionally, Part 1, Section 5 of the Agreement provides that "[e]ach Member will pay annual dues to ***."

Moreover, the Members of *** are able to choose the management in the form of a Board of Trustees that is "elected at each annual meeting of Members" as set forth in Part 2, Section 1.B of the Agreement.

3. *A Sole Business Purpose of Supplying Goods, Services or Insurance at Cost*.

The third prong is met because ***** sole business purpose is to insure its Members against ********** liability claims at cost. *** does not operate for a profit.

***** sole business purpose is statutorily mandated under ********** ****, which governs "unincorporated interindemnity or reciprocal interinsurance contracts between members of a cooperative corporation…whose members consist solely of ********** in California, which contracts indemnify solely in respect to **********claims against those members, and which do not collect in advance of loss any moneys other than contributions by each member to a collective reserve trust fund or for necessary expenses of administration."

**********provides that an initial trust corpus fund must be "established by contributions from…participating members." Subdivision (a)(4) strictly mandates that "[a]ll funds held in trust that are in excess of current financial needs shall be invested…in eligible securities, as defined in Section 16430 of the Government Code…"

**********further provides that such "income earned on the corpus of the trust fund shall be the source for the payment of the claims, costs, judgments, settlements, and costs of administration contemplated by the interindemnity arrangement, and to the extent the income is insufficient for the those purposes, the board of trustees shall have the power and authority to assess participating members for all amounts necessary to meet the obligations of the interindemnity arrangement in accordance with the terms thereof."

Hence, according to applicable statute, ***** funds are used only for the purpose of covering actual costs of claims and operating expenses.

The use of funds to cover actual costs and effectively operate on a not-for-profit basis is also strictly governed by the terms of the Agreement. Part 2, Section 5 of the Agreement governs Assessments from Members. Part 2, Section 5.B.1 provides that "Assessments may be levied by the Board of Trustees for the following purposes" only:

a. Assessments to Pay Claims and Operating Expenses. Whenever the Board of Trustees believes, in its sole discretion, there will be a deficiency in *** Fund Income for the next succeeding twelve month period with respect to the payment of the expenses described by Part 2, Section 2.D.
b. Assessment to Increase *** Fund Corpus. To increase the *** Fund corpus after the favorable vote of the Members as described by Part 2, Section 7.D.1.
c. Assessments for Additional Coverage. To (1) increase the limits of liability for the **********liability coverage provided by Part 1, Section 6; (2) provide **********liability coverage to a Covered Person or to a Covered Entity; or (3) to provide an aggregate limit charge in accordance with Part 1, Section .B.

Thus, pursuant to Section 5.B.1, the levying of Assessments is limited to operating needs, which evidences ***** sole business purpose to insure its Members at cost.

4. *The Right of Members to a Return of the Premiums Paid in Excess of the Amounts Necessary to Cover Losses and Expenses*.

Lastly, the fourth characteristic is also met because Assessments (i.e., the equivalent of premiums) that are not paid out to satisfy claims paid during a given year or ***** operating expenses are effectively used to reduce the Members' Assessments for the following year, as is laid out in the provisions of Part 2, Section 5.B.1 of the Agreement. Per these provisions, Assessments are only levied when the Board of Trustees believes there will be a deficiency in *** Fund Income for the following year to cover costs; to the extent the expenses are sufficiently covered, future Assessments need not be collected.

Furthermore, upon dissolution of ***, excess funds are to be repaid to the Members. Specifically, Part 2, Section 8 of the Agreement provides that, in the event of dissolution, "the Board of Trustees will promptly apply to any court of competent jurisdiction for a court- supervised dissolution and winding up of the business and affairs of ***, with any final distribution of the *** Fund Corpus to be made pro rata to the persons verified as Members as of the date *** is dissolved." Thus, any excess funds are not the property of ***, but rather the property of the Members subject to return.

Accordingly, *** is properly classified a "cooperative" or "mutual association" pursuant to RTC section 24405.

II. *** net income from business activities for or with its members, and for or with nonmembers conducted on a nonprofit basis, is subject to a deduction under RTC section 24405.**

Specifically, RTC section 24405(a) states that:

> In the case of other associations organized and operated in whole or in part on a cooperative 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, shall be an allowable deduction.

Regulation section 24405 further provides that cooperative or mutual associations are not permitted a deduction under RTC section 24405 if their income is principally derived from the sale of tangible personal property.

As shown above, *** is a "cooperative" or "mutual association" pursuant to RTC section 24405. Furthermore, since *** does not sell tangible personal property, the proscription of Regulation section 24405 does not apply, and each of ***** revenue streams described herein relates to business activities conducted for or with its members, or with nonmembers on nonprofit basis, pursuant to the strict, collective provisions of **********, Gov. Code section 16430, and ***** Trust Agreement. As such, any net income remaining after applying *****operating expenses and payment of claims qualifies for the deduction under RTC section 24405.

CONCLUSION

For the reasons set forth above, and based upon the facts and law stated above, *** qualifies as an "association organized and operated in whole or in part on a cooperative or mutual basis" in accordance with RTC section 24405. Accordingly, *** qualifies for the deduction under RTC section 24405(a).

Please be advised that the tax consequences expressed in this Chief Counsel Ruling are applicable only to the named taxpayer and are based upon and limited to the facts you have submitted. In the event of a change in relevant legislation, or judicial or administrative case law, a change in federal interpretation of federal law in cases where our opinion is based upon such an interpretation, or a change in the material facts or circumstances relating to your request upon which this opinion is based, this opinion may no longer be applicable. It is your responsibility to be aware of these changes, should they occur.

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

Tax Counsel