State of California

Board of Equalization
Legal Division (MIC:82)

M e m o r a n d u m

135.0170

To: Mr. Wayne Hopkins
Supervising Tax Auditor II
Out-of-State District Office

January 10, 1992

From: David H. Levine
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Subject: The R--- H---
S- -- XX-XXXXXX

This is in response to your mini-memo dated December 3, 1991 which referred to us a memorandum dated November 22, 1991 from Out-of-State District's New York Office concerning an audit of the R--- H---. The hotel is owned by a group of insurance companies who assert that they are immune from use tax imposed upon the hotel by virtue of the in-lieu provisions of the insurance tax. (See Cal. Const. Art. 13, § 28(f), Rev. & Tax. Code § 12204.) The insurers base their argument on the recent case of Mutual Life Insurance Company of New York v. City of Los Angeles (1990) 50 Cal.3d 402. In a recent memorandum, Tax Counsel Stella Levy agreed that the Mutual Life case extended the in-lieu provisions to any activity of the insurance company. She noted further that if the R--- H--- was operated as a joint venture which did not independently qualify as an insurer paying the California gross premiums insurance tax, then the in-lieu provisions would not apply to activities of the hotel.

On October 4, 1984, a consortium of insurance companies entered into a participation agreement whereby they committed as a group to loan up to $53,000,000 to H--- T--- A---, the person who owned the R--- H--- at that time. C--- (C---) was the principal and C2 (previously A---), H---, and I--- were the participants. A copy of the Participation Agreement was provided by B--- N--- of C2 along with his letter dated November 14, 1991. Mr. N--- notes that C--- was responsible for administering and servicing the investment and maintaining appropriate books and records of accounts on behalf of all the participants. Mr. N--- also notes that C--- thereafter purchased the ownership interests of H--- and I---. In July 1986, C--- and C2 acquired ownership of the R--- H--- by deed in lieu of foreclosure. In January 1990, they sold the hotel. The tax liability in question arose during this period of ownership of the hotel by C--- and C2.

Mr. N--- asserts two basic arguments against assessment of the tax. One is that section 17 of the Participation Agreement specifically states that neither the execution of the agreement nor the sharing in the investment or the security for the investment is intended to be, nor shall it be construed to be, the formation of a partnership or joint venture between the parties. As discussed below, this is not determinative. Mr. N---s' other basis against the assessment is his belief that joint ownership of the hotel should not bar application of the in-lieu provisions of the insurance tax when joint ownership of the hotel is a result of normal insurance business. He reaches this conclusion based on the Mutual Life case. However, the Mutual Life case stands for the opposite conclusion.

In Mutual Life, the court examined the case of Massachusetts Mutual Life Insurance Co. v. City and County of San Francisco (1982) 129 Cal. App. 3d 876. In that case, the court had concluded that an insurer did not obtain the benefits of the in-lieu provision when it engaged in an activity that was not a traditional insurance activity. In Mutual Life, the Supreme Court disapproved the Massachusetts Mutual rule and concluded instead that the in-lieu provisions apply to any activities of an insurance company, even if those activities are not traditional insurance activities. Thus, whether an activity is a traditional insurance activity is not relevant in determining whether the in-lieu provisions apply. This means that the fact that joint ownership was the result of normal insurance business is simply not relevant to this analysis. Rather, we look only to whether the person engaged in the selling activity is a separate person, within the meaning of Revenue and Taxation Code section 6005, who is not an insurer registered in California and paying the insurance gross premiums tax. If the seller is a separate person who is not an insurer, that person does not obtain the benefits of the in-lieu provisions even if owned by one or more insurance companies. Thus, a subsidiary wholly owned by an insurer must pay state income taxes unless the subsidiary itself is a registered insurance company, even if that subsidiary's only business is the administration of the employers' self-funded group health plans (an activity traditionally performed by insurance companies).

A joint venture may be defined as a undertaking by two or more persons to carry out a single business enterprise for profit. (Davis v. Kahn (1970) 7 Cal.App.3d 868, 877.) Joint ventures are similar to partnerships except that a partnership is usually formed to engaged in an ongoing business, while a joint venture is typically formed for a single transaction or series of transactions. (Rickless v. Temple (1970) 4 Cal.App.3d 869, 893.) The laws regarding creation and existence of partnerships apply with equal force to joint ventures. (Zeibak v. Nasser (1938) 12 Cal.2d 1, 11-12.)

Whether a joint venture has been created depends on the intention of the parties. (Universal Sales Corp. v. California Press Manufacturing Company (1942) 20 Cal.2d 751, 762-65.) "The acts and conduct of the parties engaged in the accomplishment of the apparent purposes may speak above the express declarations of the parties to the contrary." (Id. At 765.) A joint venture may be assumed as a reasonable deduction from the acts and declarations of the parties. (Rickless v. Temple, supra, 4 Cal.App.3d at 893.) In order for there to be a joint venture, there must exist between the parties a mutual right to control the management or operation of the enterprise and a common purpose in which all parties have a mutual interest. (Ragghianti v. Scherwin (1961) 196 Cal. App.2d 345, 351.) However, that there is no complete control over every part of the venture vested in each venturer does not negate the existence of a joint venture since, by agreement, one venturer may be given the duty of management of the joint venture enterprise or any part of it. (Lyon v. MacQuarrie (1941) 46 Cal.App.2d 119, 124-25.)

During the period in question, C--- and C2 were the participants to the Participation Agreement. Section 10 of that agreement relates to the fault by the borrower, which was presumably the reason the participants acquired the R--- H--- by virtue of the deed in lieu of foreclosure. That section includes the following provisions: "The parties shall . . . determine by mutual agreement whether and in what manner and to what extent any and all rights . . . shall be exercised; such determination shall also extend to the management and disposition of the property . . ."

Section 11 relates to acquisition of title pursuant to foreclosure or other proceedings. Under that provision, the principal was required to convey to the participants as tenants in common their share of that property if so requested. Under subsection (a), Property Management, the principal was required to appoint as manager of the property an entity experienced in the management of such properties. Subsection (b) provided that the parties, C--- and C2 were to share prorata "in all revenues, proceeds, liabilities, costs, and expenses of every kind and nature whatsoever incurred in the operation, maintenance, repair, and improvement of the property." Further, section 16 of the agreement specifically provides that the parties assume all risk of loss in connection with their investment to the extent of their respective shares.

It is our opinion that this is an agreement for a joint venture whereby the venturers have designated one among them to act as the manager of the enterprise. It is clear throughout the agreement that the participants share in all costs and benefits of the enterprise. We believe that section 17 of the agreement, which states that it is not intended nor should it be construed to be a partnership or joint venture agreement, cannot override the otherwise clear provisions of the agreement that show it is an agreement to form and operate a joint venture.

In summary, it appears that there are two possibilities: the hotel was operated by C--- and C2 as mere investors; or the hotel was operated by the joint venture. Under the Participation Agreement, we believe that C2 can in no way be regarded as a "mere" investor. Rather, we conclude that the Participation Agreement is one to form a joint venture. We recommend that the audit be completed on this basis. If you have further questions, feel free to write again.

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cc: Ms. Stella Levy