



BEFORE THE STATE BOARD OF EQUALIZATION  
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of )  
FARMERS AND MERCHANTS BANK OF LONG BEACH )

Appearances:

For Appellant: H. V. Ketcherside, its Vice President;  
F. T. Ritter, Certified Public Accountant

For Respondent: W. M. Walsh, Assistant Franchise Tax  
Commissioner; James J. Arditto, Franchise  
Tax Counsel

O P I N I O N

This appeal is made pursuant to Section 27 of the Bank and Corporation Franchise Tax Act (Chapter 13, Statutes of 1929, as amended) from the action of the Franchise Tax Commissioner in denying the claim of the Farmers and Merchants Bank of Long Beach for a refund of tax in the amount of \$429.96 for the taxable year ended December 31, 1938.

Prior to 1937 Appellant had acquired numerous parcels of improved real estate through foreclosure proceedings or conveyances in satisfaction of obligations. These properties were held for sale, but while being so held were rented when it was feasible to do so. The rental income and the expenses attributable to the properties were reported in Appellant's returns of income, but a deduction was not claimed for depreciation. Several of the properties were sold in 1937. The sole question here at issue is the propriety of the action of the Commissioner in reducing the basis for computing gain or loss from the sales, prescribed by Section 21 of the Act, by the amount of depreciation allowable under Section 8(f) during the period the properties were held by Appellant.

It is the contention of the Appellant that the properties thus acquired were not " . . . used in the trade or business" of the taxpayer, that depreciation was not allowable with respect to them under Section 8(f) and cannot, therefore, be taken into consideration in computing the adjusted basis for gain or loss on the sale of the properties. Appellant argues that under Sections 54 and 61 of the State Banking Act, it is prohibited from engaging in the real estate business or acquiring real estate, other than premises essential to the conduct of its banking business, except through foreclosure proceedings, and that in such cases the tenure of its ownership is limited to the time required for liquidation and may not exceed ten years.

We are of the opinion that the contention of the Appellant cannot be sustained. Section 8(f) of the Act was adopted from

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Section 23(1) of the Federal Revenue Act of 1936 and corresponding provisions of prior Federal Acts, and as there employed the words "property used in trade or business" have been construed to mean property "devoted to the trade or business" of the taxpayer. Kittredge v. Commissioner, 88 Fed. 2d 632. It has not been deemed essential that depreciable property be actively used in the trade or business of the taxpayer, or that the particular use be the principal business of the taxpayer. Kittredge v. Commissioner, supra; Yellow Cab Co. v. Driscoll, 24 Fed. Supp. 993; Independent Brick Company 11 B.T.A. 862; Lincoln Cotton Mills, 15 B.T.A. 680; P. Dougherty Company, 5 T.C. 791. It is true that Appellant is not engaged in the real estate business, and in fact is prohibited by law from so doing, but is engaged in the business of loaning money upon the security of improved realty, and the acquisition of title through foreclosure must be regarded as an intimately related aspect of that business. By virtue of its mortgage or deed of trust the Appellant acquired an equitable or legal interest in the property, which was "devoted" to its trade or business in a most essential capacity, i.e., securing its funds against the default of borrowers, and no less essential to that function was the acquisition of the whole of the property through foreclosure proceedings, its subsequent maintenance, and sale.

This precise point was passed upon by the Circuit Court of Appeals for the Fifth Circuit in A. L. Carter Co. v. Commissioner, 143 Fed. 2d 296, where in answer to the same contention made by the Appellant here, it was said,

"The management and administration of foreclosed property is an essential ingredient of the business of financing." 143 Fed. 2d 297.

While this case involved a lumber company which, in addition to its regular business, constructed and financed the sale of homes, the principles set forth therein are equally applicable to a bank which conducts similar activities with respect to foreclosed properties.

We regard as without merit the Appellant's contention that the action of the Commissioner resulted in employing in the measure of its tax, income of the Appellant in excess of its "true income", in alleged violation of the principle of Pacific Co. v. Johnson, 285 U.S. 480. That decision, which upheld the inclusion in the measure of the tax of the interest from tax-exempt bonds of the State and its political subdivisions, does not, however, in any way suggest that the "net income" which is the measure of the tax be determined other than in accordance with the provisions of the Act. In any event, if the measure of Appellant's tax for any of the years during which it held the properties exceeded its net or true income, that result flowed from its own neglect to claim the allowances for depreciation to which it was entitled, and Appellant may not by virtue of that neglect depart from the plain provisions of the Act as respects the determination of gain or loss from the sale of the properties. Cf. United States v. Lucey, 274 U.S. 295; Virginian Hotel Corporation v. Helvering, 319 U.S. 523.

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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 that the action of Chas. J. **McColgan**, Franchise Tax Commissioner, in denying the claim of the Farmers and Merchants Bank of Long Beach for refund of a tax in the amount of ~~\$429.96~~ for the taxable year ended December 31, 1938, pursuant to Chapter 13, Statutes of 1929, as amended, be and the same is hereby sustained,

Done at Sacramento, California, this 24th day of July, 1947, by the State Board of Equalization.

Wm. G. **Bonelli**, Chairman  
Geo. R. Reilly, Member  
J. H. Quinn, Member  
Jerrold L. **Seawell**, Member

ATTEST: Dixwell L. Pierce, Secretary