BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal)
)
of)
)
PEOPLE'S FEDERAL SAVINGS &)
LOAN ASSOCIATION)

Appearances:

For Appellant: Mark Scholtz, Attorney at Law

For Respondent: John S. Warren, Associate Tax Counsel

O P I N I O N

This appeal by People's Federal Savings & Loan Association is made pursuant to Section 26077 of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying its claim for refund of franchise taxes in the amount of $6,981.39 for the income year 1951.

Appellant began doing business in California as a Federal Savings & Loan Association on December 17,1938. In determining its annual franchise tax it takes a deduction from gross income for additions to a reserve for bad debts,, This deduction has been 0.2 percent of its outstanding loan accounts which is the limit allowed by the Franchise Tax Board. In 1954 Appellant filed a claim for refund with the Franchise Tax Board asking a refund of the tax it had paid for the year in question in excess of that which it would have paid had it been allowed to make an addition to its reserve for bad debts and claimed a deduction therefor in the amount of 1% of its outstanding loan accounts.

All deductions are a matter of legislative grace and are limited by the terms of the legislative enactment. We must, therefore, examine the claim in the light of the statute which covers this deduction, Section 24121f of the Revenue and Taxation Code (now Section 24348) allows a deduction for:

> "Debts which become worthless within the income year, or, in the discretion of the Franchise Tax Board, a reasonable addition to a reserve for bad debts,.."

Acting pursuant to the discretion granted by this Section, the Franchise Tax Board has issued a series of regulations dealing generally with the bad debt deduction and with reserves for bad debts, It has not, however, issued a regulation specifically covering reserves for the bad debts of building and loan associations. An informal ruling adopted in 1943, however, provides that building and loan associations may use the reserve method, provided certain conditions are met and that a reasonable addition to the reserve for bad debts is 0.2 percent of the outstanding loan accounts at the end of each income year.

Appellant asserts that an annual addition limited to 0.2 percent of its outstanding loan accounts is inadequate and that the refusal of the Franchise Tax Board to allow it an annual deduction of 1% of its outstanding loan accounts amounts to an abuse of the discretion granted by the statute. The Franchise Tax Board argues that 0.2 percent is adequate, especially as to this Appellant which has never suffered a bad debt loss, and that the Appellant has failed to show that it has abused the broad discretion granted it by the statute.

The issue, therefore, is whether the Franchise Tax Board abused its discretion in denying Appellant's request for an addition of 1% of its outstanding loan accounts to its reserve for bad debts.

In Appeal of First Federal Savings and Loan Association of Hollywood, September 26, 1939, we considered whether the tax administrator could deny savings and loan associations the right to use the reserve method of taking a deduction for bad debts, Our holding was that the tax administrator could not deny savings and loan associations the right to use the reserve method and that 0.3 percent of insured accounts was not an unreasonable addition. We did not, however, purport to assume the task of saying what is the proper addition to a reserve for bad debts for a savings and loan association. That is the function of the tax administrator, Our duty is only to determine whether his ruling is so clearly arbitrary or capricious as to amount to an abuse of discretion.

It must be recognized that a "heavy burden" rests upon one who wishes to have a determination of the tax administrator set aside in this area. See: S. W. Coe & Co. v. Dallman, 216 Fed. 2d 566 (CA 7th, 1954); Union National Bank & Trust Co. of Elgin, 26 T.C. No. 65 (1956); and C. P. Ford & Co., Inc., 28 B.T.A. 156 (1933). Appellant has failed to sustain this "heavy burden" though it has raised several points in an effort to show an abuse of discretion. We shall deal with each of these in turn.

Appellant's first argument is that the annual addition to its reserve for bad debts allowed by the Franchise Tax Board is inadequate to let is prepare for a possible depression, This argument is based upon a misunderstanding of the purpose of a bad debt reserve. When faced with the same argument the Circuit Court in S. W. Coe & Co. v. Dallman, supra, said, at page 570:

> "From a viewpoint of sound business management it may be wise to accumulate surplus funds against future contingencies but such is not the type of reserve contemplated by . . . [this Section] and is not allowable as a deduction for bad debt reserve,"

Appellant also points to the various reserves of higher amounts required by state and federal law and would have us infer from such fact that a reasonable reserve for bad debts would be much greater than that which it is allowed under the Franchise Tax Board ruling, Again there is a difference in purpose between such reserves and the one for bad debts. The former are to protect the depositors from possible mismanagement of their funds. The latter is designed to provide a more convenient means of arriving at net income than allowing bad debts to be deducted only as they are sustained. It is primarily for the convenience of the taxpayer who may, if he wishes, instead deduct bad debts as they becoma worthless. Inasmuch as the two types of reserves serve different functions, the amounts allowed or required for the one do not prove that the other is unreasonably small.

Appellant next points to the Federal tax laws which allow savings and loan associations a deduction for additions to a reserve for bad debts until such reserve equals twelve percent of their deposits, and argues that the Franchise Tax Board should establish a definite ultimate goal to be reached, presumably by allowing deductions at least in the amount it claims until such goal is reached. Initially we wish to observe that the State need not treat items in the same manner that the Federal government does and that in many areas, e.g., the treatment of capital gains, there are major differences. The conformance or non-conformance of the State law is solely a matter of legislative policy, In the absence of a similar statute the failure of the Franchise Tax Board to follow the Federal law is neither arbitrary or capricious.

Finally, Appellant argued at the oral hearing that a

20 year average should be used to determine what is a reasonable addition to a reserve for bad debts, This is the method approved by the Federal Government for use by commercial banks. We have roughly calculated the deduction which would be allowed Appellant were this method used here and conclude that a comparison of the result thereby reached and the deduction actually allowed fails to show an abuse of discretion. Appellant sustained no losses during the 13 years of existence prior to the year involved here. For the other seven years we have taken the average losses of savings and loan associations in the State as shown by Appellant's Exhibit A, Adding 13 years of no losses and 7 years of average losses we see that the average for 20 years would be .675 percent. While this is roughly three and one-half times the amount allowed by the Franchise Tax Board, we do not feel it shows a clear abuse of discretion considering that Appellant has never actually suffered any losses and that its accumulated reserve is 1.2% of its outstanding loans, which is equal to almost twice the 20 year average.

We must, accordingly, conclude that Appellant has failed to show an abuse of discretion on the part of the Franchise Tax Board and that, therefore, its claim for refund was properly denied,

O R D E R

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 the Franchise Tax Board in denying the claim of People's Federal Savings and Loan Association for refund of franchise taxes in the amount of $6,981.39 for the income year 1951 be and the same is hereby sustained,

Done at Los Angeles, California, this 24th day of June, 1957, by the State Board of Equalization.

Robert E. McDavid, Chairman

Paul R. Leake, Member

J. H. Quinn, Member

George R. Reilly, Member

_____, Member

ATTEST: Dixwell L. Pierce, Secretary