57-SBE-019

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of

SILVER GATE BUILDING AND LOAN ASSOCIATION

Appearances:

For Appellant: Thomas G. Cross, Certified Public Accountant

For Respondent: A. Ben Jacobson, Associate Tax Counsel

O P I N I O N

This appeal by Silver Gate Building and Loan Association is made pursuant to Section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying its protests to proposed assessments of additional franchise tax in the amounts of $304.77 and $491.68 for the income years 1951 and 1952, respectively,

The sole issue in this appeal is the propriety of the disallowance by the Franchise Tax Board of deductions claimed by Appellant for bad debt expense on a reserve basis for the years in question.

Appellant has been doing business as a building and loan association in California since 1890 and for many years has maintained Loan Reserve accounts as required by this State's Building and Loan Association Act and by the Federal Savings and Loan Insurance Corporation. Up to and including the years in question it did not maintain a separate reserve account for bad debts. Commencing in 1950 and continuing through the years in question, it claimed deductions for bad debts on its franchise tax returns in annual amounts approximately equal to ,002 of its outstanding loans. The amounts of the claimed deductions were credited on its books to the Loan "Reserve account, in addition to the amounts required by the State act and Federal agency mentioned above. Appellant has had no actual bad debts from the date of incorporation to and including the years here involved. In 1955 Appellant for the first time requested and received from the Franchise Tax Board permission to deduct for bad debts on the reserve method.

Section 24348 of the Revenue and Taxation Code (formerly Section 24121f of the Code and Section 8(e) of the Bank and Corporation Franchise Tax Act) allows a deduction for bad

debts "...or, in the discretion of the Franchise Tax Board, a reasonable addition to a reserve for bad debts."

Prior to 1943 the Franchise Tax Commissioner, the predecessor of the Franchise Tax Board, did not allow building and loan associations to use the reserve method for the deduction of bad debts. In 1943, the Commissioner notified the California Savings and Loan League by letter that, subject to certain conditions, building and loan and savings and loan associations would be allowed to use the reserve method (see Appeal of Huntington Park Savings and Loan Association, decided by this Board on November 1, 1955). The, substance of this letter was incorporated in an unpublished office ruling in 1943 as follows:

> "Beginning with the taxable year 1943 (income year 1942), an association may elect to claim annually a deduction for bad debts in its return on a reserve basis, such deduction to be equivalent to ,002 of its outstanding loan accounts at the end of each income year providing it files with the Commissioner (within a reasonable period from 2/26/43) a statement setting forth that it has elected to use the 'reserve method! for future years. Once the election has been made it becomes binding for all subsequent years unless permission is requested and granted by the Commissioner to change to the actual bad debt write-off method."

On June 28, 1952, the Franchise Tax Board issued regulations which were incorporated in the California Administrative Code. They provide in part that a taxpayer may elect either the reserve or the specific charge off method in his first return, subject to approval by the Franchise Tax Board, and that permission of the Franchise Tax Board must be requested before a change in method is adopted, They also provide that a taxpayer who has established the reserve method and maintained proper reserve accounts may deduct a reasonable addition to the reserve. (Title 18, California Administrative Code, Sections 24121f(1) and 24121f(4)).

The Franchise Tax Board disallowed the deductions for 1951 and 1952, the earliest years then open. Its position is that Appellant did not elect to adopt the reserve method in accordance with the ruling, the regulations or other instructions and did not maintain a proper bad debt reserve account. It argues that no abuse of it's discretion has been shown. Appellant contends that although it failed to take deductions for years prior to 1950, it has always been on the reserve method

because it maintained a loan Reserve Account, and that it made no change in 1950, or the year in question, requiring the advance approval of the Franchise Tax Board.

We are not prepared to say that the maintenance of a statutory loan reserve account proves that Appellant was using the reserve method of treating bad debts. To the contrary, there is nothing in the maintenance of the loan reserve account to prevent a deduction on the basis of actual bad debts.

Appellant also argues that it is not bound by the requirements of an unpublished office ruling, but it admits that it began to claim the deductions only after it learned of the ruling in 1950. While the ruling was not aptly phrased for application in 1950, in that it required the election to use the reserve basis to be made within a reasonable time after February 26, 1943, it did place the Appellant on notice of the need to inform the Franchise Tax Board of the taxpayer's election. Ordinary prudence would seem to dictate that further inquiry be made or that a statement of election be filed.

Moreover, for the years 1950 through 1952, special instructions for the preparation of returns furnished to building and loan associations contained the following language:

> "BAD DEBT DEDUCTION. Associations which claim a reserve for bad debts, in accordance with instructions which have been issued, are required to complete Schedule G on the return form. All bad debt losses sustained from acquisition of properties or for other reasons are required to be charged to the reserve.
>
> Associations which have not obtained permission to use the reserve method are required to claim deduction for losses in the year in which such losses occurred." (Emphasis-added.)

The Legislature by its enactment of Section 24348 of the Code has made the deduction of a reasonable addition to a reserve for bad debts subject to the discretion of the Franchise Tax Board. Unless the disallowance by the Franchise Tax Board of the deduction claimed by Appellant was arbitrary and capricious, constituting a clear abuse of the discretion vested in that Board, its action must be sustained. No such abuse of discretion has been demonstrated. In many years of operation Appellant has suffered no bad debt losses, it did not, prior to or during the years in question, maintain a separate reserve for bad debts and, finally, it had ample notice that the use of such a reserve was subject to approval by the Franchise Tax Board.

Appeal of Silver Gate Building and Loan Association

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, pursuant to Section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Silver Gate Building and Loan Association to proposed assessments of $304.77 and $491.68 for the income years 1951 and 1952, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 19th day of August, 1957, by the State Board of Equalization.

Robert E. McDavid, Chairman

George R. Reilly, Member.

J. H. Quinn, Member

_____ Member

_____, Member

ATTEST: Dixwell L. Pierce, Secretary