BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
SOUTHERN CALIFORNIA CENTRAL)
CREDIT UNION)

Appearances:

For Appellant: J. Wallace McKnight
Attorney at Law

For Respondent: Burl D. Lack
Chief Counsel

OPINION

This appeal is made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Southern California Central Credit Union against proposed assessments of additional franchise tax in the amounts of $228.86 and $497.06 for the income years 1958 and 1959, respectively.

Appellant is a credit union operating on a co-operative basis pursuant to the California Credit Union Law. (Fin. Code, §§ 14000 to 16004.) Its members consist of individuals, and other credit unions and their officers. Appellant made 1,508 loans to members in 1958, amounting to $2,179,114.65; the following year it made 3,293 loans totalling $3,378,225.13.

In addition to loaning funds to members, appellant conducts a "Pool Operation" for member credit unions. Many smaller credit unions have-excess funds which they wish to put out at interest but because the demands of their businesses fluctuate widely over short periods the normal investments available to credit unions are not practicable, For instance,

savings and loan associations typically require that funds be deposited a minimum of three or six months before any interest will be paid thereon. To meet this need, appellant accepts funds from member credit unions on a demand basis, paying about the same rate of interest as savings and loan associations but on a daily basis. The total funds in the pool have remained at fairly constant levels.

At the beginning of the first year in question, 1958, appellant had a total of $50,000 on depositwith five separate savings and loan associations. Deposits were limited to $10,000 each. Additional deposits were made during the year, raising the total on deposit to $120,000 in twelve savings and loan associations. These deposits were retained throughout 1959. In January of 1959 appellant also invested $100,000 in Bank of America time certificates which were held until July of that year. Interest earned on the deposits and the certificates amounted to $3,273.31 for the income year 1958, and $6,385.01 in 1959.

At the beginning of 1958 appellant had $150,000 in loans from banks outstanding. This balance was reduced to $62,000 in February of that year and was completely paid off the following month. Appellant borrowed $50,000 from banks in March of 1959; this debt was reduced to $30,000 in May and completely discharged in July of that year. Appellant's total interest expense, including amounts paid to member credit unions on the "Pool Operation," was $8,906.02 in 1958 and $9,669.50 in 1959.

Appellant filed a tax return, for each of the years in question, reporting gross receipts and expenses as follows:

	1958	1959
Interest Earned:		
Loans to members	$205,771.73	$268,074.09
Loans to member credit unions	-0-	15,783.18
Investments	3,273.31	6,385.01
Other	-835.19	1,415.26
Total Gross Receipts	$209,880.23	$291,657.54
Less Expenses (excluding bad debts)	103,463.59	136,648.34
Net earnings	$106,416.77	$155,009.20

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In addition to expenses for salaries, stationery and supplies, appellant had indirect expenses attributable to depreciation, rent, leasehold improvements and insurance, totalling $8,354.02 for 1958 and $12,285.16 for 1959, The average ratio of appellant's investments in savings and loan accounts and bank time certificates to total assets was 3.470 percent for 1958 and 5.495 percent for 1959.

Appellant reported and paid the minimum tax for the income years 1958 and 1959, The Franchise Tax Board, however, determined that the interest income earned on appellant's savings and loan deposits and bank time certificates was subject to tax and notices of proposed assessment were issued accordingly. Following appellant's protest, these assessments were revised to allow deductions of $100 per year for expenses incurred in producing the taxable income.

Appellant raises two issues: First, whether the interest income earned on its investments., is taxable; second, whether $100 per year is an adequate allowance for the expenses incurred in producing that income.

Section 24405 of the Revenue and Taxation Code allows an association organized and operated on a cooperative basis a deduction in computing taxable income for "all income resulting from or arising out of business activities for or with their members ...or when done on a nonprofit basis for or with nonmembers." Appellant takes the position that its investment income arose from business activities done on a nonprofit basis with nonmembers. This position is grounded upon a contention that the funds which were invested had been borrowed from banks or member credit unions and upon the fact that the interest expense of borrowing such funds exceeded the interest income derived from their investment.

We have previously held on several occasions that interest earned on investments of the same or similar type as those involved here was taxable. These cases have all held that such income is not deductible under the above provision as income from business "for or with" members. (Appeal of Woodland Production Credit Assn., Cal. St. Bd. of Equal., Feb. 19, 1958; Appeal of Credit Union, California Teachers Assn., Cal. St. Bd. of Equal., July 19, 1961; Appeal of California State Employees Credit Union No. 1, Cal. St. Bd. of Equal., Dec. 13, 1961; Appeal of Sacramento Bee Credit Union, Cal. St. Bd. of Equal., Dec. 13, 1961.

Any remaining question concerning the deductibility of interest from appellant's investments has been set at rest by a recent decision by the Third District Court of Appeal in Woodland Production Credit Assn. v. Franchise Tax Board,, *225 Cal. App. 2d [37 Cal. Rptr. 231]. There, a cooperative, engaged in making loans to its members received interest from investments in United States. bonds. Reasoning that section 24405 was intended to exclude from tax the savings or price adjustments produced by a cooperative in carrying out the purpose for its existence,, the court concluded that the statutory phrase "business activities" applies only to a cooperative's transactions with *or* as agent for its patrons, who may be either "members" or "nonmembers." The court held, that the investment of reserves or surplus in interest-bearing securities is not a business activity for the purpose of the statute and that the bond interest was therefore not deductible;

Upon the principles announced by the court in the above decision, appellant's income from investments with banks and savings 'and loan associations may not be deducted' because those transactions did not constitute "business activities" within the meaning of the controlling statute.

Appellant contends that even if its investment income is not deductible under section 24405, such income is not taxable 'because it had deductible interest expenses which', exceeded that income. It is argued that the invested funds consisted of amounts borrowed from banks or from member credit., unions under the "Pool Operation.." It is also stated that when the demands of members for' loans exceeded the funds on hand, appellant was faced with the choice of either liquidating. its investments. or borrowing the required amount from a bank. A short term need for additional funds was at times met by borrowing from a bank since this was, depending upon the particular circumstances, more economical than withdrawing investments which produced interest only after they *were* held for a minimum period.

Since all of the funds which appellant had on hand were commingled, it cannot be said that the investments were made specifically with borrowed funds rather than amounts from

*Advance Report Citation; 225 A.C.A. 361;

other sources. The only definite statement that can be made is that appellant invested excess funds which were not required to serve its members. When the demands of its members for loans, exceeded its available resources, appellant had the choice not only of liquidating investments or borrowing, it could also choose to curtail its loan activity. Clearly, appellant's purpose in securing additional funds was to meet the demand of its members for loans. The cost of borrowing such funds, therefore, is allocable to business done with members. Since the income from business with members is not taxable, the expenses allocable thereto are not deductible.' (Rev. & Tax. Code, § 24425; Security-First Nat'l Bank v. Franchise Tax Board, 55 Cal. 2d 407, 424 [11 Cal. Rptr. 289, 359 P.2d 625], appeal, dismissed, 386 U.S. 3 [7 L. Ed. 2d 16].)

Finally, appellant contends that respondent's allowance of a $100 deduction for the expenses allocable to appellant's investment income is inadequate, arbitrary and unreasonable. Using the average ratio of investments to total, assets, appellant argues that indirect expenses alone, attributable to investment income, amounted to $289.89 and $675.07 for the years 1958 and 1959, respectively.

Respondent states that its experience has been that the expenses of credit unions attributable to taxable and nontaxable income is not proportionately the same and that the greater portion of the expenses incurred are applicable to business done with members. For that reason, respondent has established the practice of allowing a deduction for expenses equal to one percent. of the investment income or $100, whichever is greater. This was the practice followed in the instant appeal.

It is well established that respondent's determination is presumptively correct and the burden is on the taxpayer to show that he is entitled to the claimed deduction. (Todd v. McColgan, 89 Cal. App. 2d 509, 514 [201 P.2d 414]; City Ice Delivery Co. v. United States, 176 F.2d 347; Thomas J. Barkett, 31 T.C. 1126; Herbert Davis, 26 T.C. 49.) Appellant's entire argument rests upon the premise that its indirect expenses should be allocated to income in the proportion that the assets producing that income bore to total assets. Aside from testimony to the effect that this is a standard accounting practice, the record is bare of any factual support for this method. Where two different types of business were conducted under

the same roof, the federal courts have rejected a similar method of allocating expenses based on the percentage of the income derived from each business, where it was apparent that the costs of producing income were not substantially the same in each endeavor. (Campbell County State Bank, Inc. v. Commissioner, 311 F.2d 374; Bank of Kimball v. United States, 200 F. Supp. 638.)

Appellant's formula itself is arbitrary and there is no evidence to show that the $100 allowance by respondent is inadequate. In view of the nature of the investments involved here, the relatively few accounts they entailed and the minimal number and complexity of the transactions which they required, we find nothing which would compel us to reverse or adjust the Franchise Tax Board's determination.

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 Southern California Central Credit Union against proposed assessments of additional franchise tax in the amounts of $228.86 and $497.06 for the income years 1958 and 1959, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 3d day of February, 1965, by the State Board of Equalization.

Chairman

Member

Member

Member

Member

ATTEST: Secretary