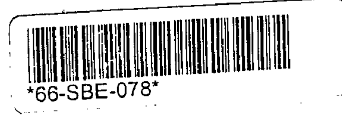

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
MID-CITIES SCHOOLS CREDIT UNION)

Appearances:

For Appellant: Rodney A, Stanton, Manager
B. F. Jameson, Treasurer

For Respondent: A. Ben Jacobson
Associate Tax Counsel.

OP I'N ION

This appeal is made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of Mid-Cities Schools Credit Union against proposed assessments of additional franchise tax in the amounts of $1,240.29 and $1,211.53 for the income years 1957 and 1958, respectively.

Appellant, a California corporation, is a credit union which operates on a cooperative basis, Its members are teachers and other school employees in Compton, California, and the surrounding area.

Appellant is primarily engaged in loaning money to its members. During the years on appeal such loans totalled:

Income Year	Number of Loans	Aggregate Amount of Loans
1957	2,032	$1,538,945.98
1958	1,895	1,235,598.03

Interest was derived from these loans and also from the investment of excess funds, Funds in excess of amounts needed for

loans to members and for operating expenses were invested in United States government securities, and in shares in savings and loan associations and in other credit unions,

Appellant also operated an optional "Summer Salary Plan." Many of appellant's members were paid on a ten-month basis, leaving two months in the summer when they received no paychecks. Under the "Summer Salary Plan" the participating member deposited his ten monthly checks with appellant, appellant prorated the total annual take-home pay over a 12-month period, and then issued twelve smaller monthly checks throughout the year to the member.

At the beginning of each school year appellant's liability under the "Summer Salary Plan" was zero; by the end of the school year its liability had risen to about $500,000. That liability was extinguished during the summer months as checks were issued to participating members. Amounts deposited with appellant during the school year under the "Summer Salary Plan" which were not needed to make current payments to participating members or to defray expenses were invested in government securities and shares in savings and loan associations and in other credit unions. During the income years **1957** and 1958 appellant realized interest income totalling $3,753.50 and $5,497.50, respectively, from the investment of such excess funds,

The first issue raised by this appeal is whether the interest income derived by appellant from investment of funds received under the "Summer Salary Plan" is deductible.,

Section 24405 of the Revenue and Taxation Code permits associations organized and operated on a cooperative basis to deduct from their gross income "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 contends that the operation of the "Summer Salary Plan" constituted a business activity with members, and that income derived from investing amounts deposited. by members is deductible under the above provision,

In Woodland Production Credit Ass'n v. Franchise Tax Board, 225 Cal. App. 2d 293 [37 Cal. Rptr. 231], the court dealt with a similar question, In that case a credit association primarily engaged in the business of making loans to its members received interest from investments in United States bonds,, The court reasoned that "section 24405 of the Revenue and Taxation Code was intended to exclude from tax the savings or price adjustments produced by a cooperative in carrying out the purpose of its existence, and therefore the phrase "business activities" applied only to a cooperative's

transactions with or- as agent for its patrons. The court concluded that the investment of reserves or surplus in interest-bearing securities was not a business activity of the cooperative for the purpose of the statute and that the bond interest was therefore not deductible,,

in reliance on the Woodland case, we held that a credit union was not entitled to deduct income derived from its investment of surplus funds with savings and loan associations. (Appeal of Southern California Central Credit Union, Cal. St. Bd. of Equal., Feb. 3, 1965.) Recently we similarly denied a credit union a deduction of income from investments of its funds in credit unions which were not its members. (Appeal of Los Angeles Firemen's Credit Union, Inc., Cal, St, Bd., of Equal., June 28, 1966.)

We see no reason to distinguish the instant..case from the cases cited, The fact that the. invested funds in question were received from members participating in the "Summer Salary Plan, " with the understanding that they would be held by appellant only temporarily does not alter the fact that appellant was investing surplus funds with nonmembers for profit, Those investments were of essentially the same character as those in the above cited cases. That being so, appellant is not entitled under section 24405 of the Xevenue and Taxation Code to deduct income realized from such investments.

The next issue is whether interest expense on funds borrowed by appellant is allocable to income not included in the measure of the franchise tax, If the interest expense is allocable to income not included in the measure of the franchise tax, it is not deductible, (Rev. & Tax, Code, § 24425.)

When the demands of members for loans exceeded the funds on hand, it was customary for appellant to borrow money. Appellant elected this course of action as being more profitable than that of liquidating investments prior to their maturity dates or their next interest dates and thereby losing interest income, This borrowing practice resulted in interest expense .to appellant of $5,770.83 in 1957 and $3,657.84 in 1958. Appellant contends that since this interest expense was incurred in order to increase investment income, i.t is directly related to such taxable income and is therefore deductible,

In Appeal of Southern California Central Credit Union, supra, and Appeal of Los Angeles Firemen's Credit Union, Inc., supra, we held that the credit unions there involved could not deduct interest expense incurred in borrowing funds. We stated in both opinions:

> 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].)

No distinguishing facts or arguments have been presented in the instant case. We, therefore,, conclude that appellant is not entitled to deduct the interest expense which it incurred in borrowing funds.

The final issue is whether appellant may offset-its personal property taxes against its franchise taxes pursuant to section 23184 of the Revenue and Taxation Code, which provides that "Financial corporations may off set against the franchise tax the amounts- paid during the income year ... as personal property taxes ...."

Respondent's proposed additional assessments were based in part on its determination that no such offset was available, Since the. initiation of this appeal, respondent has stated that it will allow an offset of that proportion of the total personal property taxes paid which appellant's nondeductible income bears to its total income.

There is no provision in the law for the apportioned offset proposed by respondent, Section 23184 of the Revenue and Taxation Code merely provides that financial corporations may offset against their franchise tax "the amounts paid" for personal property taxes, It is undisputed that appellant is a financial corporation. Section 23184 contains no qualification or limitation applicable to a financial corporation which may receive deductible as well as nondeductible income. In the absence of such an express limitation, respondent must comply with the terms of section 23184 and allow an offset of the full amount of the personal property taxes paid,

Three other issues have be-en settled since this appeal was filed: (1) respondent has agreed to an increased deduction for expenses attributable to nondeductible income by allowing all. direct labor costs relating to the servicing of investments producing nondeductible income plus one half of 1 percent of appellant's nondeductible income; (2) respondent has agreed to allow deductions for certain amortizable bond premiums; and (3) appellant has conceded that an annual fee

which it paid to the Commissioner of Corporations pursuant to section 16000 of the Financial Code is not allowable as an offset .

ORDER

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing theref or ,

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 protests of Mid-Cities Schools Credit Union against proposed. assessments of additional franchise tax in the amounts of $1,240.29 and $1 ,211.53 for the income years 1957 and 1958, respectively, be modified as follows :

1. To allow appellant to deduct its direct labor costs relating to the servicing of investments producing nondeductible income plus one half of 1 percent of its nondeductible income in each year in question,

2. To allow appellant to deduct its amortizable bond premiums in each year in question,

3. To allow appellant- an offset of the full amount of personal property taxes paid for each of the years in question.

In all other respects, the action of the Franchise Tax Board is sustained,

Done at Sacramento , California, this 15th day of December. , 1966 , by the State Board; of Equalization.

________________, Chairman
Paul R. Leake, Member
John W. Lynch, Member
[signature], Member
________________, Member

ATTEST: [signature], Secretary