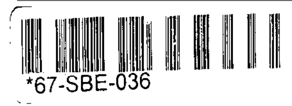

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
)
HOME SAVINGS AND LOAN ASSOCIATION;)
HOME SAVINGS AND LOAN ASSOCIATION)
AS SUCCESSOR IN INTEREST TO HOLLYWOOD)
SAVINGS AND LOAN ASSOCIATION; and)
PASADENA SAVINGS AND LOAN ASSOCIATION,)
HOME SAVINGS AND LOAN ASSOCIATION,)
ASSUMER AND/OR TRANSFEREE)

Appearances:

For Appellants: Walter S. Weiss
Attorney at Law

For Respondent : Crawford H. Thomas
Associate Tax Counsel

O P I N I O N

These appeals are made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on protests against proposed assessnents of additional franchise tax as follows:

Appellant	Income Year	Amount
Home Savings and Loan Association	1956	$ 5,078.97
	1957	13,086.04
	1958	81,389.33
	1959	747,224.08
Home Savings and Loan Association as Successor in Interest to Hollywood Savings and Loan Association	1955	878053
	1956	4,620.93
Pasadena Savings and Loan Association, Home Savings and Loan Association, Assumer and/or Transferee	1955	35,051.09

After these appeals were filed, Home Savings and Loan Association (hereafter referred to as appellant), paid the amount of tax assessed against it for the income year 1959. Its appeal for that year will therefore be treated as from the denial of a claim for refund, in accordance with section 26078 of the Revenue and Taxation Code,

Several of the issues originally involved in these appeals have been eliminated through concessions by the parties. These concessions will be reflected in our order.

The primary questions which remain are in connection with appellant's computation of a deductible addition to its bad debt reserve for the income year 1959.

Appellant Home Savings and Loan Association was organized and began business in 1889. During the years 1950 through 1957 it acquired substantially all of the assets and assumed substantially all of the liabilities of eight other savings and loan associations.

In computing its franchise tax for the income year 1959, appellant deducted an addition to its bad debt reserve in the amount of approximately $9.8 million. It arrived at this sum by computing the average ratio of its losses to its outstanding uninsured loans during the 20-year period of 1928 through 1947. The factor thus developed, 2.28 percent, was applied to an amount which appellant regarded as its outstanding uninsured loans at the end of 1959. Included in "outstanding loans" was a figure of $24,361,880, representing "loans in process." These "loans in process" consisted of amounts which appellant was obliged to disburse to building contractors when and if they completed certain construction work, pursuant to agreements between the contractors, the borrowers, and appellant.

Respondent determined that the deductible percentage of loans should be computed by combining appellant's loss experience with that of the eight other associations whose assets were acquired and whose liabilities were assumed by appellant. This combination of loss experience for the years 1928 through 1947 resulted in a loss factor of .74088 percent. Respondent also determined that the "loans in process" should be excluded from the outstanding loans to which the loss factor was to be applied. As calculated by respondent, the allowable deduction was approximately $2 million. It appears that this figure would be increased to approximately $3 million as the result of certain concessions by respondent regarding items includible in outstanding loans, other than the item of "loans in process."

We shall first consider whether the computation of the deductible percentage should be based only on appellant's experience or on the combined experience of itself and the other associations whose assets it acquired.

The controlling statute, section 24348 of the Revenue and Taxation Code, allows the deduction of "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."

Pursuant to this statute, respondent adopted regulation 24348(a), title 18, California Administrative Code. The regulation applies exclusively to savings and loan associations and is applicable to income years beginning after 1958. The pertinent portions of the regulation are as follows:

> * * *
>
> (3) Rules Governing Use of Reserve Method. In determining the ratio of losses to outstanding loans for income years, beginning after December 31, 1958, a moving average is to be employed on a basis of 20 years experience, including the income year . ... However, in lieu of the moving average experience factor an association may use an average experience factor based on any 20 consecutive years after the year 1927; provided, that for any 20-year period selected the association must use its own bad debt loss experience for the years that it was in existence during the period selected and the average bad debt loss of similar associations located in this State for such years as are necessary to complete the 20-year period. Associations which have not been in existence 20 years, see subparagraph (3)(ii).
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> * * *
>
> (ii) A newly organized association or an association which arises as the result of a merger, consolidation or the acquisition of substantially all of the assets of a predecessor association without sufficient years' experience for computing an average as provided for above will be permitted to

> set up a reserve commensurate with the average experience of other similar associations with respect to the same type of loans. If such association has not been in existence during all or part of either of the 20-year periods described at the beginning of this paragraph, it must use an average bad debt loss experience factor consisting of its own bad debt losses during the years for the period selected plus the average bad debt losses of similar associations located in this State for such years as are necessary to complete either of the 20-year periods selected. The average bad debt losses of such associations for the years 1928 to 1947, inclusive, has been determined by the Franchise Tax Board to be 0.6 percent, The average bad debt loss for each year from 1928 to 1947, inclusive, is as follows:
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> * * *
>
> The statewide average loss allowance is applicable for all income years beginning after December 31, 1958.... In determining the average experience of similar associations the experience of associations which have ceased operations prior to the effective date of this regulation was disregarded. However, if such association was operated by a successor association as the result of a merger, consolidation or transfer of substantially all of the assets of its predecessor, the average experience of the acquired association with respect to the same type loans was combined with the average experience of the successor association.
>
> * * *

Appellant does not contend that the amount allowed by the Franchise Tax Board as an addition to its bad debt reserve was inadequate from the standpoint of anticipated losses. The essence of its position is that in computing its loss factor it has used only its own experience and thus has followed, literally, the terms of the regulation.

Although the regulation refers to use of an association's "own experience" it implicitly assumes the propriety of using the loss experience of a predecessor. This is apparent in the language of subdivision (3)(ii), which recognizes the

propriety of substituting the loss experience of associations which have ceased business if the operation is continued by a successor association,

The regulation in question is similar to Mim. 6209, 1947-2 Cum. Bull. 26, as supplemented by Rev. Rul. 54-148, 1954-1 Cum. Bull. 60, and Rev. Rul. 57-350, 1957-2 Cum. Bull. 144, which together spelled out the policy of the United States Commissioner of Internal Revenue in granting bad debt reserve deductions to banks, pursuant to a federal statute substantially identical with the one that concerns us here. (Mim. 6209 and supplemental rulings are now superseded by Rev. Rul. 65-92, 1965 Int. Rev. Bull. No. 14, at 8.)

As pointed out by appellant, federal authorities have held that a bank must use its own previous experience in computing its loss factor despite changes in policy, in management, or in location. (First National Bank of La Feria, 24 T.C. 429, aff'd, 234 F.2d 868; Union National Bank and Trust Co. of Elgin, 26 T.C. 537; Northern Bank, T.C. Memo., Dkt. No. 72770, Dec. 3, 1962; American State Bank v. United States, 176 F. Supp. 64, aff'd, 279 F.2d 585.) The Internal Revenue Service has also ruled that a bank may not use the loss experience of another bank from which it acquired certain loans, where the other bank continued in business. (Rev. Rul. 54-133, 1954-1 Cum. Bull. 60.)

More recent cases, however, involving facts more closely resembling those before us, have given a broad interpretation to the term "own experience."

In Pullman Trust and Savings Bank v. United States, 235 F. Supp. 317, aff'd, 338 F.2d 666, a so-called "Old Bank," formed in 1907, was in the process of liquidation from the year 1930 until it was dissolved in 1940. A "New Bank," incorporated in 1932, had the same officers and directors as the "Old Bank," used the facilities of the "Old Bank," assumed substantially all of its deposits and liabilities and took over certain assets of the "Old Bank." It was undisputed that the "New Bank" could utilize the loss experience of the "Old Bank" for the years 1928-1931. On the disputed question, the court held that the two banks were in fact a single and continuous operation and that Mim. 6209 required the "New Bank" to use the combined loss experience of both banks for that part of the 20-year period when both banks were in existence. The court stated that:

> Plaintiff's use of the Old Bank's loss experience during the latter's period of liquidation does not constitute, as

> defendant contends, utilization of a substituted loss experience; rather it merely recognizes that plaintiff once consisted of two parts both of which combined to comprise the whole. (235 F. Supp. 317, 324.)

Subsequently, in Union National Bank of Youngstown v. United States, 237 F. Supp. 753, it was held that a bank incorporated in 1932 could not be required to use its own loss experience for the first year of its existence, a year in which it incurred no losses. Instead, it was permitted to use for that year the loss experience of two older banks part of whose liabilities had been assumed by the taxpayer bank and substantially all of whose assets had been assigned to the taxpayer bank as security for notes it received as consideration for its assumption of liabilities. The court found that the taxpayer bank was an entity independent of the old banks, but said that:

> ... in the interpretation of mimeograph 6209 and subsequent rulings, the courts should read into the words "own experience" the qualification that the experience should be meaningful. (237 F. Supp. 753, 764.)

In Peoples Bank and Trust Co. v. United States, 260 F. Supp. 622, the Federal District Court reviewed the application of Mim. 6209 to the plaintiff bank which was the survivor of a series of mergers with five other banks. The mergers, occurring during the 1950's, were with other banks, each of which had been in business for a similar period. The significance of the case is that both sides and the court agreed that some sort of combined percentage should be used.

As previously stated, appellant acquired substantially all of the assets of eight other savings and loan associations. Appellant has not described the complete details of all the acquisitions, but it has been alleged by respondent and not denied by appellant that all of the acquisitions constituted mergers under the provisions of the California Savings and Loan Association Law and under the provisions of the Revenue and Taxation Code. Paraphrasing the language of Pullman Trust and Savings Bank v. United States, supra, 235 F. Supp. 317, aff'd, 338 F.2d 666, appellant once consisted of nine parts which combined to comprise the whole. And, heeding the admonition in Union National Bank of Youngstown v. United States, supra, a meaningful loss experience in the case of an association

which is an amalgamation of previously existing associations may be achieved, logically, by combining the loss experience of all.

In substance, respondent has regarded appellant as a composite, whose "own experience" is the experience of all of its parts. The facts which have been presented to us do not show that this view is unsound. In our opinion, respondent's interpretation of its own regulation, supported as it is by both reason and authority, should be followed.

It is also contended by appellant that the previously described "loans in process" should be included in the figure representing outstanding loans to which the loss factor is to be applied. This issue was raised in a brief filed after the oral hearing and no evidence was presented or authorities cited in support of appellant's position. It has not been established that the "loans in process" constituted valid debts at the end of 1959 nor has it been shown that any loss was possible on these amounts, which had not yet been disbursed. Upon the record before us, we must sustain respondent's action in excluding the "loans in process" from the class of outstanding loans.

The final issue concerns a portion of the assessment against Pasadena Savings and Loan Association, for whose taxes appellant is liable. For several years Pasadena engaged in a joint venture of buying land and building and selling houses. The disputed portion of the assessment arose from the Franchise Tax Board's action in adding approximately $270,000 to Pasadena's income, an amount which was designated in Pasadena's own accounts as "Unreported Income Sale of Real Estate." Appellant has alleged that all of the income was reported, in part by appellant itself after Pasadena merged with it. Although appellant has asked us to decide this issue in the event the main question, related to the computation of its bad debt loss factor, was decided against it, it has not presented any evidence in support of its position. We cannot, therefore, decide this issue in its favor.

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

(1) that the action of the Franchise Tax Board on the protests of Home Savings and Loan Association against proposed assessments of additional franchise tax in the amounts of $5,078.97, $13,086.04, and $81,389.33 for the income years 1956, 1957, and 1958, respectively, be sustained in accordance with concessions by appellant;

(2) that the action of the Franchise Tax Board on the protests of Home Savings and Loan Association as Successor in Interest to Hollywood Savings and Loan Association against proposed assessments of additional franchise tax in the amounts of $878.53 and $4,620.93 for the income years 1955 and 1956, respectively, be reversed in accordance with concessions by respondent; and

(3) that the action of the Franchise Tax Board on the protests of Pasadena Savings and Loan Association, Home Savings and Loan Association, Assumer and/or Transferee, against a proposed assessment of additional franchise tax in the amount of $35,051.09 for the income year 1955 be modified in accordance with a concession by respondent by excluding from the measure of tax the balance of $540,658.38 remaining in the bad debt reserve of Pasadena Savings and Loan Association when that association merged with Home Savings and Loan Association.

IT IS FURTHER ORDERED, ADJUDGED AND DECREED, pursuant to section 26077 of the Revenue and Taxation Code that the action of the Franchise Tax Board in denying the claim of Home Savings and Loan Association for refund of franchise tax in the amount of $747,224.08 for the income year 1959 be modified in accordance with a concession by respondent by increasing to $408,270,584.68 the amount of outstanding loans subject to the application of the bad debt loss factor.

In all other respects the actions of the Franchise Tax Board are sustained.

Done at Sacramento, California, this 6th day of July, 1967, by the State Board of Equalization.

______________________, Chairman

______________________, Member

______________________, Member

______________________, Member

______________________, Member

ATTEST: ______________________, Secretary