BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
LA JOLLA FEDERAL SAVINGS AND LOAN)
ASSOCIATION)

Appearances:

For Appellant: Martin S. Schwartz
Attorney at Law

Frank Hardinge, Jr.
Executive Vice President,
California Savings and Loan League

For Respondent: Lawrence C. Counts,
Counsel

O P I N I O N

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 La Jolla Federal Savings and Loan Association against proposed assessments of additional franchise tax In the amounts of $9,815.15 and $10,167.55 for the income years 1961 and 1962, respectively.

The question presented is whether respondent's disallowance of appellant's additions to its reserve for bad debts In 1961 and 1962 constituted an abuse of discretion.

Appellant was formed on November 8, 1928, as La Jolla Guarantee Building and Loan Association, a California corporation. *On* November 25, 1935, appellant was federally chartered, and since that date it has engaged in business under Its present name.

Pursuant to an Informal ruling issued by respondent In 1943, applying to all savings and loan associations,

appellant elected to use the reserve method of accounting for its bad debts, As permitted by the ruling, In each of its Income years 1942 through 1958 appellant added to its reserve and claimed as a deduction a sum equal to .2 percent of Its outstanding loans. As of December 31, 1958, appellant's accumulated reserve for bad debts amounted to $207,044.95. No deductions for additions to the bad debt reserve were claimed in 1959 and 1960, but in 1959 a charge was made against that reserve in the amount of $2,280.98. Thus, as of December 31, 1960, appellant's accumulated bad debt reserve amounted to $204,763.97.

In its returns for income years 1961 and 1962 appellant claimed deductions for additions to its bad debt reserve in the amounts of $134,290.92 and $118,898.04, respectively. Those additions were computed on the basis of an average loss experience ratio of .5 percent of appellant's outstanding loans.

After an audit respondent determined that the proper average experience factor for appellant was .163 percent of its outstanding loans. This figure was obtained by using appellant's own bad debt loss experience for the years 1929 through 1947 and substituting a statewide average figure for 1928, the year in which appellant was formed. Respondent then made the following computations:

	1961	1962
Net outstanding loans	$26,546,202.25	$30,147,869.98
Bad debt ratio	.163%	.163%
(a) Tentative addition to reserve	$ 43,270.31	$ 49,141.03
Maximum reserve (3x(a))	129,810.93	147,423.09
Reserve balance at end of year, before any addition	$ 204,763.97	$ 202,526.24

Since in both years the accumulated balance in appellant's reserve for bad debts already exceeded the *reserve* ceiling, respondent disallowed the entire amounts deducted by appellant In Income years 1961 and 1962 as additions to its bad debt reserve. That action gave rise to this appeal.

At the oral hearing In this matter respondent conceded the *existence* of losses which increased appellant's bad debt loss ratio for each of the income years in question to .18 percent rather than .163 percent, Those adjustments

did not change the amounts of the proposed additional assessments, however, since appellant's accumulated reserve still exceeded the ceilings allowable under the regulation.

Section 24348 of the Revenue and Taxation Code provides:

> (a) There shall be allowed as a deduction debt8 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.

'In 1959 respondent Franchise Tax Board adopted a regulation which set forth In detail the means by which savings and loan associations were to determine allowable bad debt reserves and additions thereto. (Cal. Admin. Code, tit. 18, reg. 24348(a).) That regulation was effective for all income years beginning after December 31, 1958, and ending prior to December 31, 1961. One of the proscribed methods for computing additions to a bad debt reserve was to allow the association an annual deduction of a percentage of loans equivalent to the average ratio of losses to outstanding loans during any 20 consecutive years of its own experience after 1927. Such annual deductions were to be allowed only *In* such amounts as would bring the accumulated bad debt reserve to a total not exceeding three times the average rate applied to outstanding loans.

Respondent's regulation further provided that if a taxpayer association had *not* been In existence for all or a portion of the 20-year period selected, it was to use the average experience factor of similar associations located In the state for such years a8 were necessary to complete the 20-year period. In the event that an association could not determine the experience of such similar associations, the 1959 regulation provided that their average bad debt losses In each year after 1927 was deemed to be .2 percent. It further specified:

> The bad debt deduction allowed associations who compute their tax on the basis of 20 consecutive years after the year 1927, will be adjusted for all income years beginning after December 31, 1958, after the Franchise Tax Board determine8 the State-wide average losses of all associatlono for such years.

In 1961 respondent increased the average value of .2 percent to .5 percent, effective for income years beginning after December 31, 1958, and ending prior to December 31, 1962.

In 1963, upon completion of its study of the post-1927 bad debt experience of savings and loan associations in California, respondent adopted regulation 24348(a) as a permanent regulation, effective for all income years beginning after December 31, 1958. For purposes of this appeal that permanent regulation was substantially similar to its predecessors, except that it set forth the statewide average bad debt losses for the years 1928 through 1947. It also provided, in subdivision (3):

> ... 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 experience 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) [containing the statewide averages].

Appellant contends generally that respondent's permanent regulation 24348(a) operates to produce unreasonable, inequitable, and distorted results with respect to the allowable bad debt reserves of savings and loan associations. Specifically appellant contends that it has received discriminatory treatment under that regulation. To illustrate, appellant states that under the provisions of regulation 24348(a), an association formed in recent years is entitled to use the statewide average loss figures set forth in that regulation In computing its allowable bad debt reserve. In contrast, appellant urges that because it (the appellant) was formed in 1928 and existed during the depression years, It is obliged to use its own loss experience for those years even though that experience was not meaningful since appellant did virtually no business during those years. Appellant contends that, as a result, the newer savings and loan associations operating In the same area In which it operates are receiving an unfair competitive advantage. Appellant requests that its own loss experience for the years 1928-1935 be replaced by the statewide averages for thoae years, resulting In what appellant considers to be a more equitable loss experience factor of .520 percent of Its outstanding loans.

The Legislature, by its enactment of section 24348 of the Revenue and Taxation Code, has made the reasonableness of an addition to a reserve for bad debts a matter within the discretion of respondent. Respondent's disallowance of the deductions claimed by appellant must therefore be upheld unless appellant can sustain the heavy burden of proving that respondent has acted arbitrarily and capriciously, thereby abusing its discretion. (First Rational Bank *in* Olney, 44 T.C. 764, aff'd, 368 F.2d 164; Appeal of Silver Gate Building and Loan Association, Cal. St. Bd. of Equal., Aug. 19, 1957.)

In Its disallowance of appellant's claimed deductions respondent has followed its own regulation 24348(a). That regulation is very similar to Mim. 6209, 1947-2 Cum. Bull. 26, as supplemented by Rev. Rub. 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 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, 1965-1 cum. Bull. 112, as supplemented by Rev. Rul. 66-26, 1966-1 Cum. Bull. 41.)

Federal courts have consistently upheld the requirement In Mim. 6209 and the rulings supplementing it that a bank must use Its *own* loss experience during the 20-year averaging period selected, if it was in existence during that period. (First National Bank *in* Olney, supra; First National Bank of La Feria, 24 T.C. 429, aff'd per curl-am, 234 F.2d 868; First Commercial Bank, 45 T.C. 175.) This conclusion has been reached despite arguments similar to appellant's regarding the discriminatory results reached under Mim. 6209 and supplementary rulings. (First National Bank of La Feria, supra.) One court did hold that a bank incorporated in 1932 could not be required to use Its own experience for the first year of its existence, when it incurred no losses, because the taxpayer bank's *own* experience In that year was not meaningful. (*Union* National Bank of Youngstown, 237 F. Supp. 753.) In that case the bank was allowed to use the experience of two predecessor banks In that *one* year, but It was required to use its own experience In subsequent years. In accordance with that holding, in computing appellant's average experience ratio respondent has used the statewide average figure for 1928, the year in which appellant was formed.

Upon review of the entire record we must conclude that appellant has failed to establish any abuse of *discretion* by respondent. In computing appellant's average loss experience respondent has followed a regulation which it Issued as an exercise of Its discretion in this arcs, That regulation is very similar to a series of federal rulings which *have* been

repeatedly upheld in the federal courts. Furthermore it appears that appellant sustained no actual bad debt losses in the years 1960 and 1961, and it had bad debt losses totaling only $2,280.98 *in* 1959. When this record of actual losses is compared with the existing balance in appellant's reserve for bad debts at the beginning of each of the years in question ($204,763.97), we do not believe it can be said that appellant acted unreasonably in disallowing the deduction of further additions to that reserve. Respondent's action in this matter must therefore be sustained.

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 La Jolla Federal Savings and Loan Association against proposed assessments of additional franchise tax in the amounts of $9,815.15 and $10,167.55 for the income years 1961 and 1962, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 5th day of August, 1968, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____, Member

_____, Member

ATTEST: _____, Secretary