BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
AMERICAN SAVINGS AND LOAN)
ASSOCIATION OF CALIFORNIA,)
SUCCESSOR TO HOME MUTUAL)
SAVINGS AND LOAN ASSOCIATION)

'Appearances:

For Appellant: Neil R. Bersch
Certified Public Accountant

For Respondent: Gary Paul Kane
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 American Savings and Loan Association of California, successor to Home Mutual Savings and Loan Association, against proposed assessments of additional franchise tax in the amounts of $10,404.55 and $30,811.70 for the income years 1961 and 1962, respectively. Since the filing of the appeal, respondent has made-certain concessions whereby the tax assess-' ments for these income years will be reduced to $9,812.54 and $30,284.01, respectively.

The question presented is whether respondent properly disallowed *a* percentage of appellant's additions to its reserve for bad debts for the income years 1961 and 1962.

Appellant, like its predecessor Home Mutual Savings and Loan Association, uses the reserve method of deducting bad debts. Appellant calculated the ratio of losses to outstanding loans by utilizing the bad debt experience of Home Mutual for the selected base years, 1928 through 1947. Pursuant to the

option granted for determining bad debt losses in regulation 24348(a) subdivision (5), title 18, California Administrative Code, appellant determined the amount of losses on sales of foreclosed real estate during the base period by taking losses into account at the time of the sale. Under this method, the amount by which the basis of the property exceeds the sale price is the amount of loss recognizable. In determining the basis of the property capitalizable items are included as part of the basis.

In determining its bad debt ratio, appellant capitalized and thereby added to the basis of the property sold, expenditures totaling $18,484. However, these were described as repairs on Home Mutual's schedules and had been deducted as ordinary and necessary business expenses by Home Mutual. Respondent ultimately allowed $2,808 as capital expenditures, the amount it found expended (1) for overall renovation projects, (2) for items normally having longer life than one year, and (3) for relatively large expenditures at or near the time the property was acquired or sold. Respondent did not allow capitalization of certain "repair" expenditures, which were not in one of the three foregoing categories, and which were described as "painting and/or papering" or "painting and repairs." Three $50 payments for attorney's fees added to basis were also disallowed.

Appellant also capitalized "real property taxes' In the amount of $12,515, allegedly representing taxes owed on the foreclosed property by the former owner but paid by Home Mutual. Such payments had also been deducted by Home Mutual as ordinary and necessary business expenses. In view of the absence of accurate records appellant was unable to trace specific taxes to individual properties, lien dates, and tax periods but merely made an estimate. Fifty-percent of such real estate taxes paid during the base period were attributed to real estate sold and a portion of this amount was allocated to properties sold at a loss, based on a ratio of real estate sales at a loss to total sales. With the only exception being $72 in taxes paid during 1929 which was specifically identified, respondent disallowed the capitalization of the property taxes.

Respondent's disallowances of the "repairs," "taxes" and attorney's fees decreased the loss ratio during the base period, thereby reducing the allowable bad debt ratio for 1961 and 1962.

Appellant contends that many of the "repair" items should be added to the basis as initial painting and papering costs, or added to the basis as painting and papering required

as a condition of Home Mutual's contract of sale with the ultimate purchaser. Appellant also contends it is immaterial that the "repairs" and "taxes" of this nature had earlier been deducted as ordinary and necessary expenses by Home Mutual and also immaterial that an estimate was made of the "taxes" paid.

The burden of proving whether a payment constitutes a currently deductible expense or a capital expenditure is clearly imposed upon the taxpayer. (New Colonial Ice Co. v. Helvering, 292 U.S. 435 [78 L. Ed. 1348]; Philip Dietz, 7 B.T.A. 1048.) Lack of adequate records, even without fault, does not shift the burden. (Kirkland v. United States, 267 F. Supp. 259.) Furthermore, section 24348 of the Revenue and Taxation Code provides in part:

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

The Legislature, by its enactment of section 24348, has made the reasonableness of an addition to a reserve for bad debts a matter within the discretion of respondent. The reserve method is designed to provide a more convenient means of arriving at net income than allowing bad debts only as sustained. This convenience is primarily for the benefit of the taxpayer who may, if he wishes, instead deduct bad debts as they become worthless. (Appeal of People's Federal Savings and Loan Ass'n, Cal. St. Bd. of Equal., June 24, 1957.) Respondent's disallowance of the deductions claimed by appellant must therefore be upheld unless appellant can sustain the even heavier burden of proving that respondent has acted arbitrarily and capriciously, thereby abusing its discretion. (First National Bank in Olney, 44 T.C. 764, aff'd 368 F.2d 164; Appeal of Silver Gate Building and Loan Ass'n, Cal. St. Bd. of Equal., Aug. 19, 1957.) No showing has been made that the addition to the bad debt reserve allowed by respondent would be insufficient when compared with actual losses sustained in 1961 and 1962.

In addition, appellant has produced no evidence as to the nature of Home Mutual's expenditures for painting and papering except the schedules indicating that all the expenditures were made for repairs. A currently deductible repair is an expenditure to keep property in an ordinarily efficient operating condition, not adding to the value of property nor appreciably prolonging its life. It keeps the property in an operating condition over-its probable useful life for the uses for which

it was acquired. It is distinguishable from expenditures for replacements, alterations, Improvements or additions which prolong the life of the property, increase its value, or make it adaptable to a different use. One is a deductible maintenance charge, while the others are additions to capital investment not to be applied against current earnings. (Illinois Merchants Trust Co., 4 B.T.A. 103; Kirkland v. United States, 267 F. Supp. 259.) Normally, expenditures for painting and decorating are current expense items rather than capital expenditures (Kirkland v. United States, supra) except when incidental to a general plan of rehabilitation, improvement, alteration or modernization. (I. M. Cowell, 18 B.T.A. 997; Bank of Houston, T.C. Memo., May 31, 1960; Jones v. Commissioner, 242 F.2d 616.) Allowances were apparently made for all painting or papering in the latter category.

With respect to some of the disallowances, appellant relies on the proximity of the repair date to the sale date as evidence that the repair was performed as a condition of sale, and therefore alleges the cost thereof should be added to the basis. However, the specific properties referred to by appellant were held for years by Home Mutual. This indicates that the work performed could have been incidental repair work currently deductible. (See Estate of Walling v. Commissioner, 373 F.2d 190.) Moreover, Home Mutual's contemporaneous treatment of the transactions on its records as currently deductible expenses is indicative of the character of the transactions.

With respect to the claimed capitalizable expenditures for taxes, no showing has been made of specific payments for particular property. An estimate has been made because of the unavailability of adequate records. Under the circumstances, we are unable to conclude that appellant has met the heavy burden of proof.

Appellant has not introduced evidence establishing that the attorney's fees were paid in connection with the acquisition or disposition of the properties to which they were related, nor in connection with questions concerning the title to such properties. Accordingly appellant has not established that the attorney's fees should either be added to the cost of such properties or deducted from their selling price in determining gain or loss on their ultimate disposition. The attorney's fees could just as easily have been ordinary and necessary deductible business expenses incurred with respect to matters unrelated to title questions, not to be considered in determining the loss on the sale of such properties.

ORDER

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 American Savings and Loan Association, successor to Home Mutual Savings and Loan Association, against proposed assessments of additional franchise tax in the amounts of $10,404.55 and $30,811.70 for the income years 1961 and 1962, respectively, be modified in accordance with respondent's concessions. In all other respects the action of the Franchise Tax Board is hereby sustained.

Done at Sacramento, California, this 19th day of November , 1968, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____, Member

_____, Member

ATTEST: _____, Secretary