BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
SECURITY FIRST NATIONAL BANK)

Appearances:

For Appellant: Harrison Harkins
Attorney at Law

Joseph A. Ford
Vice President of Appellant

For Respondent: Lawrence C. Counts
Counsel

O P I N I O N

This appeal is made pursuant to section 26077 of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying to the extent of $26,959.60 the claim of Security First National Bank for refund of franchise tax- in the amount of $27,954.64 for the income year 1960. The portion of the claim which was granted, $995.04, involved an issue unrelated to that raised by this appeal.

The question presented is whether respondent's disallowance of a portion of the deductions claimed by appellant for additions to its bad debt reserve in 1960 constituted an abuse of discretion.

Appellant is a national bank organized in 1880 which does business entirely within California. Its principal office is in Los Angeles, and at the end of 1960 it had some 254 offices and branches in the state. A substantial part of appellant's business consists of receiving deposits and making loans and discounts.

Since 1943 appellant has used the reserve method in computing its bad debt deductions for state and federal

tax purposes. Respondent consented to appellant's use of such method for franchise tax purposes in a letter dated August 10, 1943. In calculating its reserve additions for the years 1947 through 1959 appellant used the methods prescribed by the Internal Revenue Service in its Mimeograph 6209 and Revenue Ruling 54-148, which base the annual reserve addition upon bad debt loss experience over a 20-year period. In making such computations for 1954 through 1959 appellant selected the years 1928-1947 as its loss experience period, and the resulting loss experience ratio (.00598567) was applied to all eligible loans outstanding at the close of each year.

In April 1959 appellant introduced to its customers a new consumer lending program entitled "Security Custom Credit Plan" (hereafter referred to as "Custom Credit"), which is a form of revolving credit. Under this plan a maximum of $2,400 is available to the approved credit applicant, against which he may draw checks for any purpose. The Custom Credit borrower agrees to pay either a specified amount or 10 percent of the outstanding balance, whichever is less, in response to monthly billings by appellant. Monthly payments and reductions of loan balances automatically increase the available credit by a like amount, up to the agreed maximum. The account need not be paid in full at any specific time as long as the borrower performs satisfactorily under the terms of his Custom Credit agreement. Custom Credit loans are unsecured and they bear interest at the rate of 1-1/4 percent per month, which is added each month to the loan balance.

At the time appellant launched its Custom Credit program in 1959 it set up general ledger accounts for Custom Credit loans separate from those for all other types of loans. Among these was a separate reserve for bad debts resulting from Custom Credit loans. Additions to that reserve were expensed and came out of operating earnings rather than being charged directly to undivided profits as was the addition to the regular bad debt reserve for all other loans.

As of December 31, 1960, appellant's books reflected the following:

	Total Loans Outstanding	Net Dad Debts-1960	Ratio
1. Custom Credit Loans	$ 36,391,358	$ 891,134	.02496
2. Other Consumer Loans	181,427,266	419,199	.00231

At the close of 1960 (before adding a reasonable addition for that year) the balance in appellant's bad debt reserve for all loans except Custom Credit loans was $21,085,782.52. The Custom Credit reserve account showed a debit balance of $245,045.03.

In its tax returns for the income year 1960 appellant's bad debt deduction totalled $3,677,583.96, and was composed of additions to its two separate bad debt reserve accounts. The first such addition ($2,524,280.72) was obtained by applying appellant's established loss experience ratio (.00598567) to all eligible outstanding loans, except Custom Credit loans, as of December 31, 1960. The second addition ($1,153,303.24) was determined by applying appellant's actual loss experience ratio during 1960 with regard to Custom Credit loans (.024958074) to the outstanding Custom Credit loans as of December 31, 1960.

After auditing appellant's books respondent disallowed the bad debt deduction claimed by appellant for income year 1960, to the extent it exceeded the amount which resulted from applying appellant's established loss experience ratio (.00598567) to all eligible outstanding loans, including Custom Credit loans, as of December 31, 1960. In actual figures this amounted to an allowance of $3,422,805.73 as a deduction, or a disallowance of $254,778.23 of the $3,677,583.96 deducted by appellant in its return for the income year 1960. Appellant paid the resulting additional proposed assessment of franchise tax and then filed a claim for refund. Respondent's denial of that claim, to the extent it related to this issue, gave rise to this appeal.

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....

This section contains provisions substantially similar to section 116 of the Internal Revenue Code of 1954. Acting within the discretion granted by the federal statute the Internal Revenue Service in 1947 issued Mimeograph 6209, 1947-2 Cum. Bull. 26, which permitted banks to use a 20-year moving average, ending with the taxable year, in computing reasonable additions to their bad debt reserves. In computing the

moving average percentage of actual bad debt losses to loans, Mimeograph 6209 provided, in paragraph 4, "the average should be computed on loans comparable in their nature and risk involved to those outstanding at the close of the current taxable year involved,"

In the event that a bank did not have 20 years of its own experience it was permitted to set up a reserve "commensurate with the average experience of other similar banks with respect to the same type of loans, preferably in the same locality, subject to adjustment after a period of years when the bank's own experience is established." (Paragraph 5 of Mim. 6209.) Such annual deductions were to be permitted 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.

Mimeograph 6209 was supplemented in 1954 by the issuance of Revenue Ruling 54-148, 1954-1 Cum. Bull. 60, which set forth an alternative method of computing additions to reserves for bad debts by banks. Under that method a bank could use an average experience factor based upon any 20 consecutive years of its own experience after 1927. Consistent with Mimeograph 6209, banks selecting a 20-year period which extended back into years for which they had no experience of their own were permitted to fill in such years with comparable data of other similar banks. (Paragraph .03.) Revenue Ruling 54-148 made it clear that all other rules utilized in the application of Mimeograph 6209 would be applicable to the alternative method, to the extent there was no inconsistency.

Respondent has issued no rulings or regulations comparable to Mimeograph 6209 and Revenue Ruling 54-148, with respect to the computation of a reasonable addition to the bad debt reserve of banks for state franchise tax purposes. However, in 1961 respondent stated that in administering section 24348 of the Revenue and Taxation Code its practice had been to follow those federal publications.

Appellant contends that respondent has improperly computed its allowable bad debt deduction for 1960 by applying the established loss ratio for the years 1928-1947 to all of its outstanding loans at the close of 1960, including Custom Credit loans. Appellant argues that Mimeograph 6209 and Revenue Ruling 54-148 require that the computation be made on loans "comparable in their nature and risk involved" to those in the experience period, and Custom Credit loans do not come within that classification because of their unique nature and the fact that they involve a much higher risk and much greater losses than conventional bank loans. In support

of its contention appellant points out that under a Custom Credit loan the borrower can repeatedly obtain new funds without furnishing any financial statement, and the loans are unsecured. In addition, the bank has no control over the use made of the borrowed funds.

Appellant urges that its contention that Custom Credit loans were not comparable to traditional bank loans has been borne out by actual experience. For example, appellant states, in 1960 its losses on Custom Credit loans were greater than the losses on all other loans combined, although Custom Credit loans outstanding on December 31, 1960, constituted only about 2-1/2 percent of the total loans subject to a reserve for bad debts. Furthermore, appellant continues, the loss ratio on Custom Credit loans in 1960 was 83 times as great as that for all other loans, and for the years 1960-1964 the average Custom Credit loss ratio was 8.6 times that on all other loans. Appellant further contends that the reasonableness of its 1960 addition to the separate reserve for bad debts on Custom Credit loans is evidenced by the fact that after it made the 1960 addition that account had a credit balance of $908,258.21, and during 1961 Custom Credit bad debts aggregating $891,134.05 were charged to that reserve, leaving an unused reserve of only $17,124.16.

Finally, appellant places reliance on the 1965 decision of the United States Court of Claims in North Carolina National Bank v. United States, 345 F.2d 544. The court there permitted the taxpayer-bank to deduct additions to two separate bad debt reserves, one for commercial loans and one for time-payment loans, both additions being computed under the formula prescribed in Mimeograph 6209. The court reasoned that the application of the taxpayer's loss experience ratio on commercial loans to its time-payment loans would be unfair, because the two classifications of loans were not comparable, in that the taxpayer's loss experience ratio on time-payment loans was seven times as great as that on commercial loans. Since the taxpayer did not have sufficient years experience in the time-payment loan field to compute its own average experience ratio, it was allowed to use the experience of a neighboring bank.

In conclusion appellant contends that its taxable income is being improperly distorted if it is restricted to a deduction for bad debts based on the loss ratio during the experience period for conventional bank loans.

Respondent argues, first, that appellant has failed to prove that its Custom Credit loans were not "comparable," as that term is used in Mimeograph 6209 and Revenue Ruling 54-148,

to any of the other loans included in appellant's selected 20-year experience period. Respondent concedes that appellant's losses and loss ratios on Custom Credit loans were high during the initial years of the program, but it contends that those high losses did not continue, and therefore appellant has failed to demonstrate that a separate reserve for Custom Credit bad debts was justified. Respondent submits the following figures showing the change in appellant's Custom Credit loss ratio as compared to its loss ratio on all other eligible loans in the years 1960-1966:

	Custom Credit	All Other Eligible Loans
1960	.025	.0021
1961	.0245	.0023
1963	.0134	.0016
1964	.0035 .0085	.0025
1965		.0024
1966	.0066	.0033
	.0053	.0031

Secondly, respondent argues that even assuming appellant were entitled to compute an addition to a separate reserve for Custom Credit bad debts, it would have to make such a computation in compliance with the rules set forth In Mimeograph 6209 and Revenue Ruling 54-148. Respondent urges that appellant has not done so here, since it used just one year of its own experience in the Custom Credit loan field to compute an addition to that separate reserve.

Finally, respondent contends that in the absence of meaningful Custom Credit loss experience, either its own or that of other comparable banks, appellant cannot utilize the provisions of Mimeograph 6209 and Revenue Ruling 54-148 to compute additions to a separate reserve account. Respondent concludes that appellant has failed to prove the reserve addition which was allowed by respondent as a deduction was unreasonable.

By its enactment of section 24348 of the Revenue and Taxation Code, which was quoted earlier, the California Legislature made the reasonableness of an addition to a reserve for bad debts a matter within the discretion of respondent. Respondent's disallowance of a portion of the deduction 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 National Bank in Olncy, 44 T.C. 764, aff'd, 368 F.2d 164; Appeal of La Jolla Federal Savings & Loan Ass'n, Cal. St. Bd. of Equal., Aug. 5, 1968; Appeal of People's Federal Savings & Loan Ass'n, Cal. St. Bd. of Equal., June 24, 1957.

Appellant states that by officially adopting the principles set forth in Mimeograph 6209 and Revenue Ruling 54-148, respondent has exercised its discretion in this area, giving advance approval to bad debt reserve additions which are computed in accordance with those federal rulings. This contention finds support in several recent federal decisions. (See Pullman Trust & Savings Bank v. United States, 235 F. Supp. 317, aff'd, 338 F.2d 666; Union National Bank of Youngstown v. United States, 237 F. Supp. 753.) However, in the instant case appellant did not compute the addition to its Custom Credit reserve in accordance with the federal provisions, since in arriving at a Custom Credit loss ratio it was unable to use either 20 years of its own Custom Credit experience or the substituted experience of other comparable banks. Since it failed to comply with Mimeograph 6209 and Revenue Ruling 54-148, appellant still carries the burden of proving that it was nevertheless entitled to the full deduction claimed under the statutory standard of a "reasonable addition." (The First Commercial Bank, 45 T.C. 175.)

Where the reserve allowed is adequate in the light of prevailing conditions to absorb current anticipated losses there is no abuse of discretion. (American State Bank v. United States, 176 F. Supp. 64, aff'd, 279 F.2d 585, cert. denied 364 U.S. 881 [5 L. Ed. 2d 103]; S. W. Coe & Co. v. Dallman, 216 F.2d 566; Appeal of Morthrift Plan, Cal. St. Bd. of Equal., Feb. 7, 1967.) Respondent allowed appellant to deduct a bad debt reserve addition for 1960 in the amount of $3,422,805.73, computed in accordance with the provisions of Mimeograph 6209 and Revenue Ruling 54-148. This brought the combined total in appellant's two bad debt reserve accounts as of January 1, 1961, to $24,263,543.22, computed as follows:

Regular Reserve, as of 12-31-60	$21,085,782.52
Custom Credit Reserve, as of 12-31-60	(245,045.03)
Combined total	$20,840,737.49
1960 Addition Allowed by Respondent	3,422,805.73
	$24,263,543.22

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Appellant's net bad debts for the years 1959 through 1965, including losses on Custom Credit loans, were as follows:

1959	$ 326,802.00
1960	1,215,806.86
1961	3,821,009.06
1962	2,103,761.57
1963	3,085,739.89
1964	6,846,162.59
1965	3,388,762.17
Total	$20,788,044.14

The average annual net bad debt loss over this 7-year period was $2,969,720.59. Thus it can be seen that the total in appellant's bad debt reserve accounts, including the 1960 addition allowed by respondent, exceeded the cumulative total of appellant's actual bad debt losses in the years 1959 through 1965. Furthermore the total reserve, after the amount allowed by respondent, was some 8 times appellant's average annual net bad debt loss for that period. It would appear that the 1960 addition allowed by respondent was adequate.

Additionally, in computing the 1960 addition to its separate Custom Credit bad debt reserve account, appellant used its own ratio of Custom Credit loans to losses for that year alone. When the Internal Revenue Service Issued Mimeograph 6209, allowing a bank to compute its reserve additions on the basis of average loss experience, a period of 20 years was selected "as representing a sufficiently long period of a bank's experience to constitute a reasonable cycle of good and bad years." (Mim. 6209, paragraph 3.) The computation of a ratio on the basis of only one year's loss experience would appear to be inconsistent with the purpose behind the use of an average, i.e., to equalize good and bad years. Furthermore, to base an estimate of future losses on just one year's experience may result in considerable distortion, particularly when that year is the first year the bank has engaged in a particular type of consumer lending, as was the case here.

We note also that in the case of North Carolina National Bank v. United States, 345 F.2d 544, relied on by appellant, although the taxpayer was allowed to deduct additions to two separate bad debt reserve accounts, the Court of Claims reauired each of those additions to be computed on the basis-of 20-year average experience-factor. Thus in that case there was compliance with the provisions

of Mimeograph 6209 and Revenue Ruling 54-148 and the equalizing purpose behind them. As was observed earlier, such compliance was lacking here, and for that reason we believe the cases are readily distinguishable.

After thorough consideration of all of the facts and circumstances we conclude that appellant has failed to show that the bad debt deduction allowed by respondent for 1960 was unreasonable, or that respondent in any way abused the broad discretion it has in this area. Respondent's action 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 26077 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying to the extent of $26,959.60 the claim of Security First National Bank for refund of franchise tax in the amount of $27,954.64 for the Income year 1960, be and the same 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