BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)

BEVERLY HILLS FEDERAL SAVINGS)
AND LOAN ASSOCIATION)

Appearances:

For Appellant: Robert John Jensen and
David E. Agnew
Attorneys at Law

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 Beverly Hills Federal Savings and Loan Association against a proposed assessment of additional franchise tax in the amount of $70,406.82 for the income year 1963.

Southland Building-Loan Association (hereafter referred to as the state association) was formed as a California corporation on December 24, 1929, and immediately began to actively engage in the savings and loan business, On June 21, 1932, the state association's board of directors decided that aggressive conduct of the business should be suspended and orderly steps should be taken to liquidate and wind up the association. This decision was implemented and by late 1936 the association's assets and membership shares were significantly reduced and its investment certificates and loans were eliminated.

Appellant has submitted the following information concerning the extent of the state association's operation

and activity during the period from June 21, 1932, through late 1936. An office was kept open and listed in the Los Angeles City Directory. It was staffed by Mr. Molony or his wife, who were officers of the corporation. Copies have been submitted of six passbooks, showing deposits and withdrawals, and five applications to open new accounts. The association had an active bank account and dividends were paid at the end of 1933. Regular and special shareholders' and board of directors' meetings were held. The association filed tax returns and submitted information to the Building and Loan Commissioner. This information was later reflected in the commissioner's annual reports.

In late 1935 the state association was contacted . . by Mr. Eugene Webb, Jr., who was interested in forming a federal savings and loan association through the conversion of a state association. His proposal was evidently well received, and on June 9, 1936, Mr. Webb was elected president and a director of the state association. On the following September 25, the shareholders authorized the conversion to federal status, and on November 6, 1936, a federal charter was issued in the name of Southland Federal Savings and Loan Association. Existing accounts and shares in the state association were converted, and active conduct of business was resumed. On January 16, 1957, the federal association's name was changed to Beverly Hills Federal Savings and Loan Association.

The federal association, hereafter referred to as appellant, uses the reserve method of claiming bad debt deductions. With respect to the year in question appellant computed the addition to its reserve by selecting the 20-year period 1928 through 1947, using the statewide average bad debt loss experience for the years 1928 and 1929, using the loss experience of the state association for the years 1930 through 1936, and using its own experience for the balance of the period. The Franchise Tax Board determined that appellant should have used the statewide average experience for the years 1930 through October 31, 1936, on the ground that appellant did not represent a continuation of the former state association. Whether this determination was correct is the first issue of this appeal. Additionally, respondent contends that appellant at least should have used the statewide experience for the period from July 1, 1932, through October 31, 1936, because the association was not actively conducting business during this time. Whether this contention is valid is the second issue of this case.

Section 24348, subdivision (a), of the Revenue and Taxation Code provides in part: "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." Regulation 24348(a), title 18, California Administrative Code, states in part:

> (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. This period of time was selected since it represents a sufficiently long period of an association's experience to constitute a reasonable cycle of good and bad years. 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 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). ...
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> (i) In. computing the moving average or alternative method. percentage of actual bad debt losses to loans, the average should be computed on loans comparable in their nature and risk involved to those outstanding at the close of the current income year involved.. ..
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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 had 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' loss for each year from 1928 to 1947, inclusive; is as follows: ....
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> 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.

The above statute and regulation represent a policy substantially identical to the federal policy in effect during the year in question.

In respect to the first issue the Franchise Tax Board states that regulation 24348(a) impliedly recognizes the propriety of using the loss experience of a predecessor association if its operation is continued by the successor as the result of a merger, consolidation or transfer of substantially all of the assets of the predecessor. (See Appeal of The United Savings and Loan Ass'n, Cal. St. Bd. of Equal. , Nov. 19, 1968, and Appeals of Home Savings and Loan Ass'n, et al., Cal. St. Bd. of Equal., July 6, 1967.) However: the Franchise Tax Board contends that the instant situation, which involved the transfer of the assets which remained after several years of inactivity and liquidation, is not the type of continuity contemplated by the regulation, and therefore appellant may not use the loss experience of the s tate association..

Respondent has not submitted any significant authority in support of its position. The above language of regulation 24348(a) does not suggest such a restriction. Nor do the relevant administrative and judicial precedents. Use of a predecessor's loss experience has been required despite that association's inactivity for several years prior to the acquisition, or its extremely low net worth. (Appeal of The United Savings and Loan Ass'n, supra; Pullman Trust and Savings Bank v. United States, 235 F. Supp. 317, aff'd, 331 F.2d 666.) Therefore we conclude that the conversion of the state association into a federal entity, in the instant case, was the type of continuation which properly requires the successor association to use its predecessor's bad debt loss experience.

The above decision requires us to consider the Franchise Tax Board's contention that appellant at least must use the statewide average experience for the period from July 1, 1932, through October 31, 1936. Respondent relied on its Legal Ruling 314, August 25, 1966, which provides in part:

> It is our opinion that the words "in existence" as used in Regulation 24348(a)(3) should be interpreted to mean "in existence and conducting a regular savings and loan business". Accordingly, the statewide average should be used for the years during which an association was inactive or in the process of liquidation. The use of the statewide average is not only more meaningful than the association's own experience for the years but also achieves the purpose of the regulations. Union National Bank of Youngstown v. U. S., 237 F.Supp. 753.

Appellant argues that the above board's reliance on Legal. Ruling 314 is misplaced. Appellant states that regulation 24348(a) provides that an association shall use its own experience for the period when it was "in existence," and argues that its computation complied with the regulation because the state association was definitely in existence during the years in question. Appellant states that regulation 24348(a) is very similar to federal Mimeograph 6209, 1947-2 Cum. Bull. 26, and argues that the case of Pullman Trust and Savings Bank v. United States, supra, held that the mimeograph represented the full exercise of the commissioner's discretion, and that a computation made in compliance with this guideline is conclusively presumed

to be valid. Therefore appellant contends that the Franchise Tax Board cannot rely on a ruling which that board has issued in addition to the regulation. Alternatively, appellant argues that the effect of the Pullman case, supra, is to shift the burden of proof to the Franchise Tax Board if it rejects a computation made in compliance with the regulation, and appellant contends that the board has not carried this burden.

However, we think that appellant has erroneously interpreted the distinction drawn by the federal district court in the Pullman case, supra. In its determination of the proper extent of the commissioner's discretion, the court did not distinguish between the mimeograph and subsequent revenue rulings, but rather it distinguished between all of these specific guidelines and an additional annual review for reasonableness made by the commissioner. The court held that if the taxpayer's computation complies with the mimeograph and the supplemental revenue rulings, then the burden of proof shifts to the Internal Revenue Service. (Pullman Trust and Savings Bank v. United States, supra, 235 F. Supp. 317, aff'd, 338 F.2d 666; Union National Bank of Youngstown v. United States, 237 F. Supp. 753.)

Therefore, in the instant situation appellant must show that its computation complies with regulation 24348(a) as supplemented by Legal Ruling 314 in order to shift the burden of proof to respondent. After review of the evidence submitted by appellant, we conclude that it has not established that the state association was "conducting a regular savings and loan business" during the period from July 1, 1932, through October 31, 1936. Consequently, appellant's use of that association's loss experience was not in compliance with the legal ruling, and appellant is not relieved of its heavy burden of proving that respondent abused its discretion. (First National Bank in Olney, 44 T.C. 764, aff'd, 368 F.2d 164.) We do not think that appellant has carried this burden, and therefore the Franchise Tax Board's determination with respect to this issue must be upheld.

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,

Appeal of Beverly Hills Federal Savings and Loan Association

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 Beverly Hills Federal Savings and Loan Association against a proposed assessment of additional franchise tax in the amount of $70,406.82 for the income year 1963, be and the same is hereby modified in that the state association's loss experience for the period from January 1, 1930, through June 30, 1932, should be used in the computation of the addition to appellant's bad debt reserve. In all other respects the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 8th day of December, 1969, by the State Board of Equalization.

John W. Lynch, Chairman

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_____, Member

_____, Member

_____, Member

ATTEST: _____, Secretary