BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
NEWPORT BALBOA SAVINGS AND)
LOAN ASSOCIATION)

Appearances:

For Appellant: Robert J. Wynne
Attorney 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 Newport Balboa Savings and Loan Association against proposed assessments of additional franchise tax in the amounts of $16,403.42, $21,762.21 and $1,593.87 for the income years 1961, 1962 and 1963, respectively. Since the filing of this appeal, respondent Franchise Tax Board has conceded that an error in computation was made and that appellant Newport Balboa Savings and Loan Association actually made an overpayment of $727.36 in tax for the income year 1963.

The question presented is whether respondent abused its discretion in determining what constituted a reasonable addition to appellant's bad debt reserve.

Appellant was incorporated in California on October 21, 1936, and actively began conducting business on November 28, 1936. It elected to use the reserve method of accounting for its bad debts. Additions to appellant's bad debt reserve were based upon a factor reached by computing the average ratio of its losses to

its outstanding loans during the 20-year period 1928 through 1947. Appellant used the state-wide average bad debt loss experience for the years 1928-1937 and its own experience for the years 1938-1947.

Originally, respondent determined that appellant 's own loss experience should have been used for the last two months of 1936 and for 1937 as well. as for the years 1938 through 1947. For administrative convenience , respondent conceded subsequently that appellant could use statewide experience for a.11 of 1936. Because no losses were incurred_ by appellant in 1937, respondent 's use of appellant's own experience for that year affected the factor and reduced the allowable addition to the bad debt reserve. That action by respondent gave rise to thi s appe al.

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....

Re gulation 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

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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). The percentage so obtained, whichever factor is used, applied to loans outstanding at the close of the income year, determines the amount of permissible reserve in the case of an association changing to the reserve method in such year ... and the minimum reserve which an association will be entitled to maintain in future years.... An association following a change to the reserve method of accounting or which continues such method for determining bad debts, may continue to take deductions from gross income equal to the current moving average or the alternative average percentage of actual bad debts times the out standing loans at the close of the income year, or an amount sufficient to bring the reserve at the close of the year to the minimum mentioned above, whichever is greater. Such continued deductions will be allowed only in such amounts as will bring the accumulated total at the close of any income year to a total not exceeding three times the moving average loss rate or the alternative method rate applied to outstanding loans.. ..

* * *

(ii) . . . 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 [sic] been deterrnined 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.... The statewide average loss allowance is applicable for all income years beginning after December 31, 1958.

Appellant contends that by requiring it to use its own bad debt loss experience during the depression years, particularly for its first full year of existence, respondent unreasonably discriminated against appellant in a manner constituting an abuse of discretion. 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 for the entire 20 years in computing its allowable bad debt reserve. An association in existence prior to the depression period has the benefit of a backlog of loans made during good times, which went bad in the 1930's. In contrast, appellant urges that because of its formation in 1936 and its existence during some of the depression years, it is obliged to use its own negligible loss experience for those years, and is thereby at an unfair competitive disadvantage.

Appellant specifically objects only to using its own experience for 1937, however: and is not urging use of statewide experience for subsequent years. Appellant maintains that because of regulatory requirements and policy considerations it is impossible for savings and loan associations to incur any losses during most of their first full year of existence, and therefore it argues that using such experience is completely meaningless.

By its enactment of section 24348 of the Revenue and Taxation Code, the Legislature 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 National 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 24-348(a). That regulation is very similar to Mimeograph 6209, 1947-2 Cum. Bull. 26, as supplemented by Revenue Ruling 54-148, 1954-1 Cum. Bull. 60, and Revenue Ruling 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. (Mimeograph 6209 and supplemental rulings are now superseded by Revenue Ruling 65-92, 1965-1

Cum. Bull. 112, as supplemented by Revenue Ruling 66-26, 1966-1 Cum. Bull . . 41.)

Federal. courts have consistently upheld the requirement in Mimeograph 6209 and the rulings' supplementing it that a bank must use its own loss experience during the selected 20-year averaging period, if it was in existence during that period, including the use of its own experience for the initial year(s) of its existence. This rule has been imposed even if the bank's losses are very low for the first year because borrowers' obligations had not yet matured. (First National Bank in Olney, supra, 44 T.C. 764, aff'd, 368 F.2d 164; First Commercial Bank, 45 T. C. 175.) The use of substituted loss experience has also been denied in cases where bad debt losses during the depression years were kept very low by the prior management's conservative loan policy, which was subsequently liberalized. (First National Bank of La Feria, 24 T .C. 429 , aff ' d per curiam, 234 F.2d 868; Union National Bank & Trust Co. of Elgin, 26 T.C. 537.)

Appellant argues that the case of Union National Bank of Youngstown v. United States, 237 F. Supp. 753 and the Franchise Tax Board Legal Ruling 314, dated August 25, 1966, control the instant situation. In the Youngstown case a depression-born bank was allowed to use the experience of two predecessor banks for its first year of existence, during which it incurred no losses, because the taxpayer bank's own experience in that year was determined not to be meaningful. However, in First National Bank in Olney, supra, and First Commercial Bank, supra, the Youngstown decision was limited to situations where the commencing financial institution represented a continuation of the business of previously existing institutions. The reasoning of that case was not regarded as applicable where the commencing institution was unrelated to the institutions from which the borrowed experience was sought. Furthermore, the above legal ruling allows use of the statewide factor for years when an association was inactive or in the process of liquidation, but does not authorize the use of that factor for periods subsequent to the. time active conduct of a savings and loan business is commenced.

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 area. That regulation is very similar to a

series of federal rulings which have been repeatedly upheld in the federal courts. Furthermore, these has been no showing that the reserve allowed by the regulation was not adequate to absorb appellant's reasonably foreseeable bad debt losses arising from current business debts. (Cf. American State Bank v. United States, 279 F. 2d 585; First National Bank in Olney, supra, 44 T.C. 764, aff'd, 368 F.2d 164; First Commercial Bank, supra, 45 T.C. 175.) Accordingly, we conclude that respondent' s action in this matter must 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,

Appeal of Newport Balboa 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 Newport Balboa Savings and Loan Association against proposed assessments of additional franchise tax in the amounts of $16,403.42, $21,762.21 and $1,593.87 for the income years 1761, 1962 and 1963, respectively, be modified in accordance with the concessions of respondent. In all other respects, the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 4th day of June, 1970, by the State Board of Equalization.

, Chairman

, Member

, Member

, Member

, Member

ATTEST: , Secretary