BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
)
FIRST FEDERAL SAVINGS AND LOAN)
ASSOCIATION OF SAN DIEGO)

Appearances:

For Appellant: Theodore J. Cranston
Attorney at Law

For Respondent: Lawrence C. Counts
Counsel

O P I N I O N

These appeals are made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of First Federal Savings and Loan Association of San Diego against proposed assessments of additional franchise tax in the amounts of $14,672.06, $24,488.26, $21,233.32, and $21,674.15 for the income years 1958, 1959, 1962, and 1963, respectively.

The issues involved in these appeals are: (1) whether appellant could defer the reporting of real estate loan fee income and (2) whether sufficient allowance was made for losses incurred during the selected base period. We shall consider the two issues separately.

I. Method of Handling Loan Fees

Appellant makes loans secured by real property. In addition to interest, it charges the borrower a loan fee in connection with the making of a loan. At the time the loan is made the amount of the fee is either deducted from the proceeds paid to the borrower or is added to the amount of the borrower's note. From 1934

until 1958, appellant recorded the loan fees on its books as income in the year in which the loan was made. It used the same accounting method for its franchise tax returns. As to other items of income and expense, appellant used the cash receipts and disbursements method.

Thereafter appellant changed its method of accounting for loan fees, treating such fees as: income over the life of the average loan. Appellant has never requested consent from respondent to file tax returns under its revised method' of accounting. In accordance with its changed concept as to the correct method of reporting this income, appellant filed claims for refund for all years prior to 1958 which were not then barred by the statute of limitations. Respondent denied the claims, appellant appealed, and this board sustained respondent's action. (Appeal of First Federal Savings & Loan Ass'n of San Diego, Cal. St. Bd. of Equal., Feb. 18, 1964.)

Respondent's proposed assessments for the years 1958 and 1959, and a substantial portion of the proposed assessments for 1962 and 1963, are also based upon respondent 's conclusion that appellant ' s, attempt to change its method of accounting with respect to loan fees without respondent's prior consent was ineffective for tax purposes. After this board's action on the prior appeal, respondent denied appellant's protests for the later years and appellant filed an appeal for the years 1958 and 1959. The deferred loan fees at issue were in excess of $140,000 for 1958 and in excess of $170,000 for 1959. Subsequently an appeal was filed for the years 1962 and 1963.

Section 24651 of the Revenue and Taxation Code provides in part:.

> (e) . . . a taxpayer who changes the method of accounting on the basis of which it regularly computes its income in keeping its books shall, before computing its income under the new method, secure the consent of the Franchise Tax Board.

In addition to the contentions raised and considered by this board in reaching the 1964 decision,' appellant here contends that the permission requirement has no applicability in the present appeals because the accounting system was merely adapted to new. facts. It

asserts that the loan fees under prior consideration were relatively smaller charges, intended to cover only initial loan costs, whereas the larger charges here in issue were designed also to cover services rendered in procuring loans. Appellant also claims that since 1964 the Federal Home Loan Bank Board, appellant's supervisory agency, has directed that associations treat such loan fees in this manner.

The applicable California legislation is based upon the federal income tax law. Accordingly, it is appropriate to consider the federal law and the cases interpreting it. Unlike interest charges received by savings institutions in their capacity as money lenders, charges for services performed in making and procuring loans are earned at the time the loan transaction is closed. (Columbia State Savings Bank v. Commissioner, 41 F.2d 923.) The charges for these services are earned at that time, whether or not the fee exceeds appellant's cost of performing such services. Accordingly, we conclude that the essential characteristic of the fee, as income accrued when the loan transaction has closed, has not changed. Furthermore, even if the Federal Home Loan Bank Board had required the deferral of loan fee income, such a directive would not dictate the tax consequences. (Old Colony Railroad Company v. Commissioner, 284 U.S. 552, [76 L. Ed. 484]; Citizens Federal Savings & Loan Association of Covington, 30 T.C. 285.)

All other grounds for reversal asserted by appellant were thoroughly considered in the former appeal. Here, as before, appellant has not established that its former method of accounting, a hybrid method, i.e., a combination of the cash receipts and disbursements method and the accrual method, failed to clearly reflect income. The practice of accruing a loan fee when the loan is made has received judicial approval (Columbia State Savings Bank v. Commissioner, supra), and the requirement of consent should not be dispensed with simply because a change is made from a hybrid accounting system to a pure cash or accrual method (cf. Dorr-Oliver, Inc., 40 T.C. 50).

II. Determination of Bad Debt Loss Ratio

Additions to appellant's bad debt reserve for the income years 1962 and 1963 were based upon its determination of an average loss ratio of 2.9 percent for its selected base period of 1928-1947. Respondent ultimately determined that the average loss ratio of appellant and its predecessors for the base period was .7166 percent, and respondent reduced the allowable, additions to the bad debt reserve

accordingly. That action by respondent is also disputed and in part gave rise to the appeal for 1962 and 1963. Appellant specifically objects to respondent's disallowance of certain claimed losses in the three categories described below:

A. Appraisals by the Federal Home Loan Bank Board.

During the 1930's the Federal Home Loan Bank Board determined that certain loans made by appellant should be reduced or written off by appellant. This review was made after appellant had foreclosed upon the real property securing the loans. During the depression years appellant and other such associations often chose not to show on their books a loss as occurring at the time of foreclosure. These obligations were not claimed as bad debts,for tax purposes for the year when the real property was acquired by foreclosure or for the year of appraisal write-down. Appellant claims the determination by the Bank Board resulted in bad debt losses which should be regarded as occurring prior to the time of the ultimate disposition of the property. No such losses were allowed by respondent.

B. Losses on Foreclosed Real Property Exchanged for Passbooks.

During some of the depression years it was virtually impossible for depositors in savings institutions to recover their investments from such institutions in the form of money. An over-the-counter discount market for such passbooks and certificates became established and was regularly quoted in the newspapers. 'During the se years, appellant would sometimes exchange foreclosed real property for passbooks or investment certificates on the basis of their respective book values. In seeking to establish losses claimed to have been sustained at the earlier time when the real property was acquired through foreclosure, appellant had no competent appraisals to determine the fair market value of the repossessed property at that time. In the absence thereof appellant sought to use as an estimated value the fair market value of the passbooks at the date of the subsequent exchanges. Respondent has rejected this concept as being contrary to established policy. Accordingly, respondent does not agree that appellant is entitled to further bad debt losses in this category.

C. Exchange .of Home Owners' Loan Corporation Bonds.

During the depression years the federal Home Owners' Loan Corporation transferred H.O.L.C. bonds to appellant and in return was assigned the rights to the unpaid balance of certain uncollectible loans together with the real property securing the obligations. Respondent determined that total losses resulting from the exchange of loans for H.O.L.C. bonds amounted to $2,967.04, pursuant to a report of the California Building and Loan Commissioner dated March 5, 1936. Accordingly, respondent disallowed the losses claimed by appellant in 1935 to the extent of $7,045.

Section 24348 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:

> (5) Foreclosures. (i) In determining the amount of bad debt loss sustained on account of foreclosures where the collateral. is taken over by the association, the fair market value of the collateral shall be established by competent appraisal.
>
> (ii) In computing bad debt losses for prior years? losses on sales of real estate acquired as a result of foreclosures may be considered as bad debt losses. The loss shall be allowed at the time of the sale if the association consistently treated such loss as having occurred at such time rather than at the date of foreclosure. In such cases proper adjustment in respect of the property shall be made as provided in Section 24916 or the corresponding provisions of prior law.

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. This convenience is primarily for the benefit of the taxpayer who instead may deduct bad debts as they become worthless. (Appeal of People's Federal Savings & 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 burden of proving that respondent has acted arbitrarily and capriciously, thereby abusing its discretion. (First National Bank in Olnes, 44 T.C. 764, aff'd, 368 F.2d 164; Appeal of Silver Gate Building & Loan Ass'n, Cal. St. Bd. of Equal., Aug. 19, 1957.)

Upon review of the entire record we must conclude that appellant has failed to establish any abuse of discretion by respondent. With respect to the matter of the Federal Home Loan Bank Board's appraisals, pursuant to regulation 24348(a), subdivision 5, supra, an association may take losses into account either at the time of foreclosure or at the time of sale of the real property, and the method used must be applied consistently throughout the entire elected base period. We cannot say that respondent has acted arbitrarily and capriciously in limiting appellant to the option contained in the regulation.

With respect to the transactions with savings depositors, the fair market value of a passbook at the time of its exchange for the real property does not represent a competent appraisal of the market value of the real property at the time it was acquired by appellant. Based upon the record before us, appellant has failed to establish that additional losses were incurred.

In regard to the exchange of loans for H.O.L.C. bonds, the parties agreed that a bad debt loss is allowed at the time of the exchange measured by the difference between the fair market value of the H.O.L.C. bonds and the net balance on the loan. The dispute revolves around the above mentioned report from the California Building and Loan Commissioner. Appellant asserts that the report applies to losses resulting from the disposition of H.O.L.C. bonds, and not to losses resulting from exchanging loans for H.O.L.C. bonds in 1935. This contention has *not* been substantiated. Since it has not been clearly established that additional losses were incurred, we are again unable to conclude that respondent has abused its discretion.

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 protests of First Federal Savings and Loan Association of San Diego against proposed assessments of additional franchise tax in the amounts of $14,672.06, $24,488.26, $21,233.32, and $21,674.15 for the income years 1958, 1959, 1962, and 1963, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 7th day of December, 1970, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____, Member

_____, Member

ATTEST: _____, Secretary