BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
INDEPENDENCE SAVINGS AND)
LOAN ASSOCIATION)

Appearances:

For Appellant: Bryan C. Hansen
Coopers & Lybrand

For Respondent: Donald McKenzie
Counsel

O P I N I O N

This appeal is made pursuant to section 26075, subdivision (a),[1] of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claim of Independence Savings and Loan Association for refund of franchise tax in the amount of $1,422 for the income year 1977.

[1] Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the year in issue.

The question presented by this appeal is whether costs incurred by a savings and loan association in connection with an application to establish a new branch office are deductible as current expenses.

Appellant is a savings and loan association organized and existing under the laws of the State of California with its principal business office in Vallejo, California. On June 15, 1979, appellant filed an amended corporation franchise tax return for its 1977 income year, requesting a tax refund. This claim for refund resulted from appellant's recharacterization of various expenses incurred in applying for a license to open a proposed branch savings and loan office. These expenses consisted of fees to study and survey the proposed branch office site, costs for preparing the application, legal fees for reviewing the application, "branch permit approval fee," and "branch filing fee." (Resp. Br. at 1.) Appellant had originally treated these branch application costs as capital expenditures but in its amended return sought to deduct the costs as current busines-s expenses.

On October 15, 1979, respondent denied the claim, referring appellant to Franchise Tax Board Legal Ruling 309, issued on August 25, 1966, which provides that costs incurred to acquire a license to operate a branch facility of a savings and loan association must be capitalized as an intangible asset.. Appellant thereupon filed this timely appeal.

In its letter of appeal, appellant cited the then recent federal district court case of N.C. Nat. Bk. v. United States, 42 A.F.T.R.2d (P-H) ¶ 78-5237, as authority for the proposition that costs associated with an application to open a new branch office are currently deductible as an ordinary and necessary business expense. Appellant's position seems to be that the branch application costs are deductible expenses because acquisition of the branch license did not create or enhance a separate and distinct asset. To support the deductibility of its branch application costs, appellant has described the license for a proposed branch office as a non-transferable privilege.

After it was learned that the Internal Revenue Service had appealed the N.C. Nat. Bk. decision, the parties herein then mutually requested deferral of action in this appeal pending the decision of the United States Court of Appeals. Following an initial panel decision

reversing the verdict of the district court, the Fourth Circuit Court of Appeals, sitting en banc, reversed its earlier opinion and affirmed the judgment of the district court allowing current deductions for the costs of planning and establishing branch offices. (Corp. v. United States, 684 F.2d 285 (4th Cir. 1982), vacating 651 F.2d 942 (4th Cir. 1981).)

Two years later, the United States Court of Appeals for the Fifth Circuit chose not to follow the NCNB decision. In Central Texas Sav. & Loan Ass'n v. United States, 731 F.2d 1181 (5th Cir. 1984), the court held that start-up expenditures made in researching and establishing new branches of a savings and loan association were capital expenditures, not deductible expenses. It is now respondent's contention that the Central Texas Sav. & Loan Ass'n case correctly states the applicable law in the instant matter. For the reasons discussed below, we agree with respondent.

Section 24343 authorizes a deduction for ordinary and necessary expenses paid or incurred during the income year in carrying on a trade or business. This statute is substantially similar to its federal counterpart, which is Internal Revenue Code section 162. Because of this similarity, the interpretations and effect given the federal provision by the federal courts are relevant in determining the meaning of the California statute. (Meanley v. McColgan, 49 Cal.App.2d 203 [121 P.2d 451 (1942); Andrews v. Franchise Tax Board, 275 Cal.App.2d 653 [80 Cal.Rptr. 403] (1969).) We further observe that deductions are a matter of legislative grace, and the burden is on the taxpayer to show that it is entitled to the deductions claimed.- (New Colonial Ice Co. v. Helvering, 292 U.S. 435 [78 L.Ed. 1348] (1934): Appeal of James C. and Monablanche A. 'Walshe, Cal, St. Bd. of Equal., Oct. 20, 1975; Appeal of American Savings and Loan Association of California, etc., Cal, St. Bd. of Equal., Nov. 19, 1968.)

The courts have long grappled with the question whether particular payments should be treated as deductible expenses or as capital expenditures. (See Welch v. Helvering, 290 U.S. 111 [78 L.Ed. 2121 (1933).) The Supreme Court has stated that an expenditure must meet five criteria in order to qualify as an allowable deduction under section 162 of the Internal Revenue Code. The item must (1) be paid or incurred during the taxable year, (2) be for carrying on a trade or business, (3) be

an expense, (4) be a necessary expense, and (5) be an ordinary expense. (Commissioner v. Lincoln Savings & Loan Asso., 403 U.S. 345 [29 L.Ed.2d 519] (1971).) In most cases, as in the instant appeal, the decisive question is whether the expenditure is ordinary and necessary. While the term "necessary" has been construed to impose the minimal requirement that the expense be "appropriate and helpful," the principal function of the term "ordinary" is to distinguish expenditures that are currently deductible from those that are in the nature of a nondeductible capital outlay. (Commissioner v. Tellier, 383 U.S. 687 [16 L.Ed.2d 1851 (1966).)

In general, an expenditure must be treated as a nondeductible capital outlay if it is made in the acquisition of a capital asset. (Woodward v. Commissioner, 397 U.S. 572 (25 L.Ed.2d 577] (1970).) "Thus an expenditure that would ordinarily be a deductible expense must nonetheless be capitalized if it is incurred in connection with the acquisition of a capital asset.' (Ellis Banking Corp. v. Commissioner; 688 F.2d 1376, 1379 (11th Cir. 1982).) The costs of acquiring a license having an economically useful life beyond the taxable year have long been treated as capital expenditures (Nachman v. Commissioner, 12 T.C. 1204 (1949), affd., 191 F.2d 934 (5th Cir. 1951); Pasadena City Lines, Inc., 23 T.C. 34 (1954); Dustin v. Commissioner, 53 T.C. 491 (1969); Surety Ins. Co. of Calif. v. Commissioner, ¶ 80,070 T.C.M. (P-H) (1980)) tor it has been said that section 162 was "primarily intended to cover recurring expenditures where the benefit derived from the payment is realized and exhausted within the taxable year." (Stevens v. Commissioner, 388 F.2d 298, 300 (6th Cir. 1968).) However, the controlling test for determining when a payment is a capital expenditure rather than an ordinary expense is whether the payment serves to create or enhance a separate and distinct additional asset. (Commissioner v. Lincoln Savings & Loan Asso., supra; Honodel v. Commissioner, 722 F.2d 1462 (9th Cir. 1984).)

In Central Texas Sav. & Loan Ass'n v. United States, supra, the Fifth Circuit Court of Appeals first noted that the continuation of a permit's value beyond one year and the one-time payment-for the permit constitute evidence that the costs expended in acquiring the permit were capital items. The court went on to opine that the character of the item for which the expenditure was made determines if it was a "separate and identifiable asset." The taxpayer in that case, a savings and

loan association organized under the laws of the State of Texas, sought business expense deductions pursuant to an amended return for start-up expenditures made in investigating four new branches, The contested branch start-up costs consisted of professional fees for economic studies of the potential market at each location, and attorney's fees and permit fees for obtaining licenses for the new branches.

In applying the separate and distinct additional asset test from Lincoln Savings & Loan Asso., the Fifth Circuit looked to the character of the branch offices for the proper tax treatment of the related expenditures and found that the taxpayer had a property interest in the branches. Under Texas law, a savings and loan association was required to obtain a lfcensa from the state savings and loan commissioner to open each new branch office. Upon approval of the permanent permit, the court stated, the savings and loan association acquired the right to receive new accounts from new customers in a new market and the right to challenge applications by other savings and loans institutions seeking to enter that same market location. The court held that the taxpayer by virtue of the license obtained a separate and identifiable business right which it exercised in each branch office, The court stated:

> Even an intangible property right, such as the right to do business, may be a capital item, [Citation.] Moreover, this right was easily valued at the time the'permit was acquired, It was measurable by the value of its deposits and the income from its loans, That the branch was not transferable is not significant.

(Central Texas Sav. & Loan Ass'n v. United States, supra, 731 F.2d at 1185.)

Consequently, it was held that the branch offices constituted separate and distinct assets and the attendant branch start-up costs were thus capital expenditures rather than ordinary and necessary business expenses.

The facts in the instant appeal bear a striking resemblance to the facts in Central Texas Sav. & Loan Ass'n v. United States, supra. Like the taxpayer in that case, appellant is a state savings and loan association. By filing an amended return, appellant similarly seeks to deduct as ordinary and necessary business expenses the

professional costs and filing fees paid in applying for a license to establish a new branch office. Moreover, during the years in question, California law likewise provided appellant, upon approval of its application for a branch license, with certain rights to conduct its business in an exclusive territory.

Under the Savings and Loan Association Law enacted in 1951 and repealed in 1983, a branch of a savings and loan association was defined as any office or other place of business in this state owned and operated by the association, other than its principal office. (Former Fin. Code, § 5056 et seq., repealed by Stats. 1983, ch. 1091, § 1, No. 6 Deering's Adv. Legis. Service, p. *806.)* An association was prohibited from operating a branch bffice without first applying for and obtaining. a license for the proposed branch from the savings and loan commissioner. (Former Fin. Code, § *6000; see* Fin. Code, S *6552,* added by Stats. 1983, ch. 1091, § 2, No. 6 Deering's Adv. Legis. Service, p. 837.) The commissioner was required to issue the license for the proposed branch if he was satisfied that the area where the proposed branch was to be located was not adequately served by existing associations and that the public convenience and advantage would have been promoted by the operation of the branch. (Former Fin. Code, § 6002; see also Fin. Code, § 6556, added by Stats. 1983; ch. 1091, § 2, No. 6 Deering's Adv. Legis. Service, p. 838.) Once approved, a license for a branch office had an unlimited life *or* duration. (Former Fin. Code, § 6006.) A licensed branch of a savings and loan association was authorized to transact all business which may have been transacted at the principal office of the association. (Former Fin. Code, § 6009; see Fin. Code, § 6550, subd. (a), added by Stats. 1983, ch. 1091, § 2, No. 6 Deering's Adv. Legis. Service, p. 837.) Thus, a branch of a savings and loan association was treated much like a separate business enterprise under the Savings and Loan Association Law.

In addition, an existing association was entitled to protection of the territorial markets of its branch offices. Upon receipt of an application for a branch license, the commissioner was required to inform associations of the name of the city or area where the proposed branch was to be located and the time and place of the required hearing for issuance of a branch license. (Former Fin. Code, §§ 6004-6005; see also Fin. Code, § 6554, added by Stats 1983, ch. 1091, § 2, No. 6 Deering's Adv. Legis. Service, p. 837.) Any existing association

or person could object to issuance of the license by appearing at the hearing and showing cause why the branch license should not be issued. (Former Fin. Code, § 6005: see also Fin. Code, § 6555, added by Stats. 1983, ch. 1091, § 2, No. 6 Deering's Adv. Legis. Service, pp. 834-838; Cal. Admin. Code, tit. 10, reg. 145.3, which provides for a minimum two-year period of preemption in the area of a new association or branch.)

Based upon our review of the California law applicable during the appeal year, we find that the status of a branch office of a savings and loan association was identical to that of the Texas branch offices described by the court in the Central Texas Sav. & Loan Ass'n case. In accordance with that opinion of the Fifth Circuit, it in our conclusion that appellant's establishment of the new branch office pursuant to the license granted by the commissioner created a separate and distinct asset. Therefore, the costs incurred by appellant in making application for the license to open the branch office must be capitalized.

NCNB Corp. v. United States, supra, on the other hand, is distinguishable in several respects. That case involved a full-service, nationally chartered bank which was actively engaged in the expansion of its services into new markets to counter increased competition in the banking industry. As part of its expansion program, the bank conducted two types of market research: (1) long-range planning studies of large geographic areas identifying future service areas; and (2) feasibility studies evaluating specific locations as potential branches. The bank treated the expenditures for these studies, as well as the costs incurred in applying to the Comptroller of the Currency for permission to open branch offices, as currently deductible expenses.

In allowing the deductions, the court in the NCNB Corp. case emphasized that the bank was regularly engaged in developing a statewide network of branch banking facilities. The court stated that, if the bank was to maintain this network and its share of the market, it was required to explore expansion opportunities and evaluate its market position by making these types of economic studies, In other words, the court's holding in NCNB Corp. was largely based upon the view that these expenditures were ordinary and necessary to expand and to protect the existing business of the bank. (See Ellis Banking Corp. v. Commissioner, supra, 688 F.2d at

1379-1386, fn. 7.) Moreover, we observe.that the bank in NCNB Corp. did not obtain a branch license but rather applied for "permission" to open branch offices. This approval to open a branch bank was neither exclusive nor transferable as is the case of the branch license in the instant appeal. (See Cal. Dept. Sav. & Loan, Policy Statement No. 80-36, July 23, 1980.)

Based upon the foregoing analysis, we conclude that the costs and fees incurred by appellant in applying for a branch license were not deductible as ordinary and necessary business expenses. Accordingly, respondent's action in this matter must be sustained.

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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 the claim of Independence Savings and Loan Association for refund of franchise tax in the amount of $1,422 for the income year 1977, be and the same is hereby sustained.

Done at Sacramento, California, this 25th day of June, 1985, by the State Board of Equalization, with Board Members Mr. Dronenburg, Mr. Collis, Mr. Bennett and Mr. Nevins present.

Ernest J. Dronenburg, Jr., Chairman

Conway H. Collis, Member

William M. Bennett, Member

Richard Nevins, Member

_____, Member