BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
PEOPLE'S FEDE'RAL SAVINGS AND)
LOAN ASSOCIATION)

Appearances:

For Appellant: Philip A. Lisman
Certified Public Accountant

For Respondent: A. Ben Jacobson
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 the claims of People's Federal Savings and Loan Association for refund of franchise tax in the amounts of $34,668 and $31,809 for the income years 1962 and 1963, respectively.

Appellant is a federal savings and loan association incorporated on December 17, 1938, under the laws of the United States. Appellant's genesis is the result of an arrangement among People's Building and Loan Association (hereinafter called PB&L), the Federal Home Loan Bank Board, and the California Building and Loan Commissioner whereby PB&L transferred a portion of its assets to appellant in consideration for savings

shares of the latter, The detail of the transaction may be summarized as follows:

Assets transferred	$2,137,368.35
Liabilities transferred	1,734,081.39
Net assets transferred	403,286.96
Consideration received-savings certificates	348,713.39
Loss incurred by PB&L	$ 54,573.57

The exchange resulted in the transfer of 83.17 percent of PB&L's total assets to appellant. The only assets retained were certain high-risk assets which the federal regulatory authority would not allow to be transferred. The retained assets were held merely for liquidation. Although PB&L, which was incorporated in 1923, continued in existence until final liquidation in 1962, it did not solicit business after appellant's inception.

Appellant uses the reserve method of computing its bad debt deduction. For income years prior to 1959 appellant used a loan loss ratio of .2 percent to determine a reasonable addition to its reserve. Appellant claimed no deduction for additions to the reserve in 1959 and 1960. For income years after 1960 appellant selected the 20-year period 1928-1947 for determining its average loan loss experience factor. In computing its deduction for the income year 1961 appellant took the position that it was a newly organized association without sufficient experience during the 20-year base period and used a loan loss ratio based on the average of similar associations located in this state. Subsequently, respondent determined that appellant was not entitled to use the state-wide industry average but, as a successor to PB&L, must use PB&L's experience for the years 1928-1937 and a combination of PB&L's and appellant's own experience for the years 1938-1947. The resulting ratio was found to be .031 percent rather than the tentative industry average of .5 percent used by appellant. Because of the size of appellant% existing reserve respondent refused to allow it any bad debt deduction for 1961 and appellant did not claim a bad debt deduction for the income years 1962 and 1963.

Thereafter, appellant completed a study of the loss experience of both PB&L and itself during the selected

20-year period and determined that the loan loss ratio should have been .56 percent. Refund claims, the subject of this appeal, were filed claiming a bad debt deduction based on this experience factor. Appellant had net uninsured loans of approximately $77 million and $97 million, as of December 31, 1962, and December 31, 196.3, respectively. As of January 1, 1962, appellant's bad debt reserve totaled $591,463.57. In its claims for refund for the income years 1962 and 1963, appellant claimed $364,926 and $334,833, respectively, as bad debt deductions. Respondent denied both claims on the ground that appellant's reserve on January 1, 1962, was well in excess of the maximum allowable reserve based upon net uninsured loans at the end of either of the income years.

I

Appellant's initial contention is that it should not have to include the loss experience of its predecessor, PB&L, in computing its bad debt experience factor and that it is entitled to use the industry average for the years 1928 through 1938.

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." Respondent's regulations set forth, in detail, the method by which savings and loan associations are to determine allowable bad. debt reserves and additions thereto for the years in question. (Cal. Admin. Code, tit. 18, reg. 24348(a).) In determining the ratio of losses to outstanding loans a moving average is to be employed on a basis of 20 years experience, including the income year. The reason for selecting a 20-year period was that it represents a sufficiently long period of organizational experience to constitute a reasonable cycle of good and bad years. However, the regulation provides that in lieu of the moving average experience factor an association may use an average experience factor based on any 20 consecutive years after 1927. The association must use its own bad debt loss experience for the years that it was in existence during the period selected. However, if the association was not in existence during the period selected, it may use the average bad debt

loss experience of similar associations located in the state for the years necessary to complete the 20-year period, (Cal. Admin. Code, tit. 18, reg. 24348(a), subd. (3).)

Respondent's regulations specifically provide:

> 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 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 .... (Cal. Admin. Code, tit. 18, reg. 24348(a), subd. (3)(ii).)

The thrust of the regulation is that an association must use its own bad debt loss experience for all years of the period selected during which it was in existence. Similarly, if the association is the outgrowth of a "merger, consolidation or the acquisition of substantially all of the assets of a predecessor association" the successor must use the predecessor's experience in determining its own experience. (Appeal of American Savings & Loan Association, Cal. St. Bd. of Equal., May 4, 1970; Appeals of Home Savings and Loan Association. et al.,, Cal. St. Bd. of Equal., July 6, 1967; Appeal of The United Savings & Loan Association, Cal. St. Bd. of Equal., Nov. 19, 1968.)

Since it is not. contended that appellant is the result of a merger or consolidation the threshold inquiry thus becomes whether appellant acquired "substantially all of the assets" of PB&L. Appellant maintains that it did not. In support of its position, appellant argues that we adopt a test used in the area of corporate reorganization, The test involves a consideration of the nature of the properties

retained, the purpose of the retention, and the amount retained (See Rev. Rul 57-518, 1957-2 Cum. Bull. 253; Moffatt v. Commissioner, 363 F.2d 262; National Bank of Commerce of Norfolk v. United States, 158 F. Supp. 887.)

While we agree that the nature and amount of property retained as well as the purpose of the retention are cogent factors, we reject the specific test and its accompanying gloss of case law. We do not believe that the factors which predominate in determining the existence or nonexistence of a corporate reorganization are identical with those used in selecting the criteria for estimating future bad debt losses. The primary concern of the former is whether the change in corporate structure results in a taxable transaction while the latter is concerned with whether the loss experience of a predecessor is meaningful to a successor.

We believe that a determination of the question must turn on a case-by-case analysis. Of primary importance is whether the successor has acquired a sufficient quantity of the assets used in the regular course of the predecessor's business so that it is, in effect, a continuum of the former operation and the bad debt experience of the predecessor is, therefore, relevant to the successor association. (Appeal of American Savings & Loan Association, supra; cf. Appeals of Home Savings and Loan Association, et al., supra; Appeal of The United Savings and Loan Association, supra.) In the instant situation, PB&L transferred slightly more than 83 percent of its total assets to appellant. This is a substantial amount. The only assets retained by PB&L were certain high-risk assets which were apparently not transferred because the federal regulatory authority would not allow the transfer. Additionally, PB&L ceased to actively solicit business after the transfer. Finally, the retained assets were held only for liquidation and not for the continuation of the business. In view of these facts we conclude that appellant acquired "substantially all of the assets" of PB&L and therefore respondent was correct in using the loan loss experience of PB&L for the years 1928 through 1938 and in using a combination of their experience from 1938 through 1947.

II

Appellant next contends that if it is required to include the loss experience of PB&L such experience should

be adjusted for certain losses. As will appear below, we do not agree.

1. Write-downs of foreclosed real estate ordered by regulatory authority.

Between 1930 and 1936 the California Building and Loan Commission and the Federal Home Loan Bank Board required appellant's predecessor, PEEL, to write down certain foreclosed real estate by an amount approximating $20,000. The write-downs were charged to depreciation and other expenses rather than reflected as the specific charge-off of partially worthless debts. In support of its argument, appellant relies on respondent's regulation which provides that where an association charges off debts in whole or in part, pursuant to an order of a supervising federal or state authority, such debt shall be presumed to be worthless in whole or in part as of the date of the charge-off. (Cal. Admin. Code, tit. 18, reg. 24348(a), subd. (2)(C).) A simple answer to appellant's argument is that the cited regulation applies only to associations currently using the specific charge-off method in determining their bad debt deduction. During the years at issue appellant was currently using the reserve method. The two methods are based upon completely different theories and are mutually exclusive. For taxpayers using the reserve method, the amount of a loss can only be determined at either the date of foreclosure or the date of ultimate disposition of the property. There is no provision authorizing the determination at an intermediate time such as the date a regulatory agency required a write down of the property on appellant's books. Thus, the cited regulation has no application to appellant and no adjustment is called for.

2. Loss on the transfer of assets from PB&L to appellant.

As noted previously, PB&L sustained a loss arising from the transfer of assets to appellant in the amount of $54,574. Appellant argues that since the loss related to loans it is equivalent to a partial write-down for worthlessness and is properly includible in the determination of the applicable loan loss experience.

In general, the loss on a loan secured by real property is determined at the time of foreclosure. However, respondent has given savings and loan associations the option of postponing that determination until the ultimate disposition of the foreclosed property. (Cal. Admin. Code, tit. 18, reg. 24348(a), subd. (5)(ii); Appeals of First Federal Savings and Loan Association of San Diego, Cal. St. Bd. of Equal., Dec. 7, 1970.) In the present situation appellant and its predecessor elected to postpone the determination of losses until the time of disposition of the property. However, appellant now seeks to compute its losses at the time of conversion from a, state chartered association into a federal chartered association.

Respondent has continually taken the position that a meaningful measure of loss can only be determined either at the time of foreclosure or at the time of ultimate disposition of the property, Between those two dates the value of property may fluctuate as was the. case here. Appellant , who elected to defer recognition of any loss until final disposition, cannot now elect to determine its losses at the time it was converted into a federal association.

3. Losses on the exchange of Home Owners' Loan Corporation (H.O.L.C.) bonds.

During the years 1934 through 1936, PB&L exchanged a substantial number of loans for H.O.L.C. bonds. Shortly thereafter, PB&L exchanged the bonds for its' outstanding savings accounts. Appellant contends that since the H.O.L.C. bonds were exchanged shortly after being acquired, their receipt and subsequent disposition was, in effect, merely an intermediate step in the liquidation of the loans. Thus, the subsequent loss on the exchange of the R.O.L.C. bonds for savings accounts should be taken into consideration in determining the actual loss on the disposition of the loans.

Respondent ' s regulations provide that "[l]osses sustained upon the exchange of real estate loans for Home Owners' Loan Corporation bonds shall be treated in the same manner. as losses on sales of real estate." (Cal. Admin. Code, tit. 18, reg. 24348(a), subd. (5).) Accordingly, at the time the real estate loans were exchanged for H.O.L.C. bonds PB&L reaiized a loss which was considered in determining their loan loss experience. (See Appeals of First Federal Savings and Loan Association of San Diego, supra.)

Appellant now contends that in computing the loan loss experience of its -predecessor an additional loss based on the subsequent exchange of the H.O.L.C. bonds for savings accounts be included. This position is untenable. The loss attributable to PB&L's loans were sustained in full at the time they were exchanged for the bonds. Any further loss is attributable to a decline in the value of the bonds, not to loans made by PB&L. Since these a.dditional losses were no different than losses on the sale of other investments and did not result from loans, they are not includible in determining PB&L's loan lass ratio.

4. Losses on foreclosed real estate to be increased by depreciation taken.

During the years 1928 through 1947, both appellant and its predecessor claimed depreciation deductions attributable to improved real property acquired through foreclosure . The effect of the depreciation deduction was to reduce the tax basis on the real property and thereby reduce the loss upon the ultimate disposition of the property, Appellant argues that for the purpose of determining the average bad debt loss experience the depreciation should be added back so as to increase the losses incurred upon the ultimate disposition of the property.

When an association elects to determine its losses at the time of ultimate disposition of foreclosed property rather than at the time of foreclosure, a portion of the loss is attributable to the exhaustion, wear and tear of the improvement on the property between foreclosure and ultimate disposition. For this reason the regulations in effect during the years at issue required that where losses were determined upon ultimate disposition of foreclosed property the basis of the property be adjusted for depreciation. (Cal. Admin. Code, tit. 18, reg. 24348(a), subd. (5); Rev. & Tax. Code § 24916.) Accordingly, in determining the applicable bad debt loss experience appellant and its predecessor may not add back depreciation in determining the losses upon the sale of property. (See Appeal of Orange Savings and Loan Association_, Cal. St. Bd. of Equal., Feb. 16, 1971.) .

5. Losses on foreclosed real estate dispositions recognizable. to the extent that the fair market value of the consideration received was less than the face value.

During the depression, PB&L acquired certain real estate through foreclosure and, thereafter, sold the property pursuant to contracts of sale. Appellant asserts that because of the risk factor inherent in such transactions the contracts were worth less than their face value at the time of receipt. Based on this appellant argues that a value lower than the face value of the contracts should be used in computing the loss on the sale of the real estate, thereby increasing the realized losses on the disposition of the real property sold by a contract of sale.

Appellant cites no authority for writing down the value of a contract of sale nor does it offer any concrete evidence tending to show what values should be assigned to the contracts. In the absence of such evidence, it must be presumed that PB&L received the face amount of the contract for the property and that no adjustment is called for.

I I I

Appellant argues in the alternative that it be permitted to establish PB&L's losses as of the date of foreclosure rather than the date of subsequent sale. Although appellant has consistently taken its losses as of the date of sale it is respondent's policy to allow a savings and loan association, retroactively, to determine its losses as of the date of foreclosure by obtaining a competent appraisal by an independent appraiser for each parcel of real estate in question. An appraisal is not required where the property is sold within six months after foreclosure or where there has been a valid appraisal by a federal regulatory agency within six months of foreclosure. In those situations the sales price or the appraisal value will be accepted as representing the fair market value of the property as of the date of foreclosure.

In this matter 125 of the 188 appraisals submitted by appellant were regulatory appraisals conducted more than six months after the date of foreclosure . Respondent rejected the appraisals submitted by appellant on the basis of its long standing policy of refusing to accept regulatory appraisals conducted more than six months after the date of foreclosure for this purpose. The reason for this policy is that during the period of 1929-1936 property values fluctuated so rapidly that an appraisal conducted more than six months after foreclosure could be utterly invalid. On the other hand,

retroactive appraisals conducted by a competent appraiser are accepted since the appraiser's competence and valuation methods are subject to verification. In rejecting the appraisal figures, respondent also pointed out that the retroactive appraisals which were submitted were not representative of all the properties on which losses had been claimed.

After a consideration of the reasons for respondent's rejection of the appraisal data we cannot say that such action was an abuse of discretion. A taxpayer appealing from an adverse determination of reasonable additions to its bad debt reserve account bears a heavy burden of proving that the Franchise Tax Board has abused its discretion, (First National Bar-ii in Olney, 44 T.C. 764, aff'd, 368 F.2d 164; Appeal of The United Savings & Loan Association, supra,) It is our considered opinion that in the instant situation. appellant has failed to carry this burden.

IV

Finally, appellant contends that regulation 24348(a> (Cal, Admin. Code, tit. 18, reg. 24348(a)), as applied by the Franchise Tax Board, does not result in a reasonable addition to its bad debt reserve and that it is an abuse of discretion and inequitable for the Franchise Tax Board to so apply it. In rejecting appellant's final argument it is worthwhile to remark once again that the Legislature, by enacting section 24348 of the Revenue and Taxation Code, has established that the reasonableness of an addition to a reserve for bad debts is a matter within the discretion of the respondent. The convenience of a reserve is primarily for the benefit of the taxpayer who may, if he chooses to do so, deduct bad debts as they actually become worthless. Respondent's disallowance of the claimed deductions 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, supra; Appeal of Silver Gate Building and Loan Association, Cal. St. Bd. of Equal., Aug. 19, 1957; Appeal of La Jolla Federal Savings and Loan Association, Cal. St. Bd. of Equal., Aug. 5, 1968; Appeals of First Federal Savings and Loan Association of San Diego, supra,) Here appellant has failed to show that the deductions were not computed in accordance with the rules set forth in respondent's regulations. Nor has appellant shown that the allowable

addition to its reserve has been computed differently than allowable additions for all other similarly situated savings and loan associations in this state. Furthermore, appellant has not shown that its actual bad debt losses in the appeal years exceeded the amount of the allowance determined and allowed by respondent. Accordingly, it is our conclusion that respondent has treated appellant neither arbitrarily nor capriciously. Therefore, 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,

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 claims of People's Federal Savings and Loan Association for refund of franchise tax in the amounts of $34,668 and $31,809 for the income years 1962 and **1963**, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 6th day of February, **1973**, by the State Board of Equalization.

Gallagher La Rue, Chairman

John W. Lynch, Member

Richard Nevins, Member

_____, Member

_____, Member

ATTEST: W. W. Dunlap, Secretary