BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

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

For Appellant: Angell, Adams & Holmes
Attorneys at Law

Peat, Marwick, Mitchell & Co.
Certified Public Accountants

For Respondent: Crawford H. Thomas
Chief Counsel

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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 Peninsula Savings and Loan Association against proposed assessments of

additional franchise tax in the amounts of $5,481.48, $5,042.47, and $13,131.64 for the income years 1959, 1960, and 1961, respectively.

Appellant has not contested the propriety of a decision by respondent that prepaid interest income reported by appellant for the income year 1962 should be allocated in the amounts of $14,654.60, $1'155.44, and $359.40 to income years 1959, 1960, and 1961, respectively. Appellant did claim that it was entitled to adjustment of its reported 1962 income to offset these allocations, and respondent has agreed. The portion of the proposed additional franchise tax arising from these circumstances is not at issue on the present appeal.

The two questions which are presented for decision are:

I. The propriety of respondent's determination that appellant must use longer useful lives than it did use in calculating depreciation on its office buildings.

II. The propriety of respondent's determination of the loss ratio to be used by appellant in calculating the allowable amount of deductions for additions to its reserve for bad debts.

I. USEFUL LIVES OF OFFICE BUILDINGS

On its franchise tax returns for the years in question appellant claimed deductions .for depreciation on its main office building and on a branch office building. The claimed amounts were calculated on the basis of a useful life of 25 years for each building. The main office was located in a concrete and steel structure which had been a grocery market. The building was purchased by appellant in 1953 for $45,000.00, and $68,900.00 was spent to convert it for use as a banking facility. The branch office was built by appellant in 1958 at a cost of $147,250.00. Respondent determined that, for purposes of calculating depreciation,

the main office had a useful life of 40 years and the branch office a useful life of 50 years.

Under California law as under federal law the taxing authority's determination of a proper depreciation allowance carries with it a presumption of correctness, and the burden of showing the determination to be incorrect is on the taxpayer. (Hotel De Soto Co., T.C. Memo., April 25, 1945; Appeal of Frank Miratti, Inc., Cal. St. Bd. of Equal., July 23, 1953; Appeal of Continental Lodge, Cal. St. Bd. of Equal., May 10, 1967.) Here appellant has offered nothing but an unsupported statement that a 25-year life is reasonable in view of the highly competitive nature of the savings and loan business. This is not enough to satisfy the burden placed on the taxpayer., and we must sustain respondent's action in requiring the use of longer useful lives in calculating allowable depreciation.

II. LOSS RATIO

In 1922 Peninsula Building and Loan Association (PBL) was chartered under the laws of the State of California. On December 10, 1936, PBL transferred substantially all of its assets to Peninsula Federal Savings and Loan Association (Peninsula Federal), a federally chartered mutual association. Those assets not acceptable to the federal regulatory agency were transferred to the Montara co., a liquidating corporation owned by the former owners of PBL.

Peninsula Savings and Loan Association (appellant) was incorporated under the laws of the State of California on April 18, 1951. On December 31, 1951, it acquired all the assets of Peninsula Federal, which then dissolved. Appellant elected to use the reserve method for bad debt deductions and selected the 20-year period from 1928 through 1947 as the base period for establishing the loss ratio to be used in making reserve calculations.

On its franchise tax returns for the years in issue appellant claimed deductions for additions to its

bad debt reserve in the amounts of $38,127.79, $45,610.99, and $132,620.89, respectively. These additions were calculated using a bad debt loss rate of 0.2 percent.1/ Respondent determined that appellant was required to use the actual bad debt loss experience of its predecessors, PBL and Peninsula Federal. At respondent's request appellant provided data for the period 1928 through 1947, inclusive, and calculated the bad debt losses to be 0.5461 percent of outstanding loans. Respondent reviewed appellant's data and made substantial adjustments, the resulting loss rate being 0.0819 percent. The maximum allowable bad debt reserve calculated using this rate is less, in each of the years on appeal; than the actual reserve of $202,951.21 which appellant had accumulated as of January 1, 1959, and respondent denied any addition to the reserve for these years. A subsequent concession by respondent regarding the treatment of contracts of sale increased the loss rate to 0.0844 percent, but did not increase the maximum allowable reserve enough to permit an addition.

Appellant argues that it should not be required to use the actual loss experience of PBL and Peninsula Federal or, alternatively, that the proper loss rate based on their experience is 0.5461 percent as calculated by appellant.

In the present case it is not denied that substantially all the assets of PBL were taken over by Peninsula Federal and all the assets of Peninsula Federal were taken over by appellant. We have held that such a continuum of bad debt experience is enough to require the successor to use the loss experience of its prede-

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1/ Apparently, the use of this loss rate was based on appellant's belief that under Regulation 24348(a), as originally issued in 1959, it was entitled to use the average loss rate of 0.2 percent presumed to have been experienced in each year after 1927 by similar associations located in this state.

cessors. (Appeals of Home Savings and Loan Association, et al., Cal. St. Bd. of Equal., July 6, 1967; Appeal of The United Savings and Loan Association, Cal. St. Bd. of Equal., Nov. 19, 1968; Appeal of Beverly Hills Federal Savings and Loan Association, Cal. St. Bd. of Equal., Dec. 8, 1969; Appeal of American Savings and Loan Association, Cal. St. Bd. of Equal., May 4, 1970; Appeal of People's Federal Savings and Loan Association, Cal. St. Bd. of Equal., Feb. 6, 1973.) The fact that the predecessor-successor relationship involves a federal and a state association is not a material factor. (Appeal of Beverly Hills Federal Savings and Loan Association, supra; Appeal of People's Federal Savings and Loan Association, supra.) Under these circumstances we must affirm respondent's determination that appellant's loss ratio should be calculated using the actual bad debt experience of PBL and Peninsula Federal.

We turn, then, to the question of the propriety of respondent's determination that the correct loss rate based on the actual experience of appellant's predecessors should be 0.0844 percent instead of 0.5461 percent. In the Appeal of Orange Savings and Loan Association, decided by this board on February 16, 1971, we noted that the Legislature, by its enactment of section 24348 of the Revenue and Taxation Code, has made the reasonableness of an addition to a reserve for bad debts a matter within the discretion of respondent. It follows that respondent's evaluation must be sustained unless appellant can carry the heavy burden of proving that respondent 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.) Appellant has raised several points in an effort to show that respondent's determination of appellant's bad debt loss ratio was erroneous and arbitrary.

One argument made by appellant is that loans in progress should be included in the loan base used in calculating the allowable deduction. Appellant indicated that it would supply authorities and citations in support

of this argument, but failed to do so. Consequently, there is no evidence that appellant or its predecessor has ever incurred a loss with respect to loans in progress. Based upon the record before us, we must sustain respondent's action in excluding the loans in progress from the class of outstanding loans.

In view of our decisions in the Appeal of Orange Savings and Loan Association, supra, and in the Appeal of People's Federal Savings and Loan Association, supra, we find no merit in appellant's arguments that respondent has misapplied depreciation, tax liens, repair costs, foreclosure costs and loan costs in determining the basis of foreclosed properties for the purpose of calculating gain or loss thereon. Appellant was aware of respondent's determinations for many months and had every opportunity to furnish additional data, or to show wherein respondent was in error. The record indicates that appellant made no effort to do either.

In view of the foregoing we find no grounds for holding that respondent acted arbitrarily or has abused its discretion. We are, therefore, constrained to affirm its determinations.

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 Peninsula 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 Peninsula Savings and Loan Association against proposed assessments of additional franchise tax in the amounts of **$5,481.48, $5,042.47,** and **$13,131.64** for the income years 1959, 1960, and 1961, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 2nd day of January, 1974, by the State Board of Equalization.

_____, **Chairman**

_____, **Member**

_____, **Member**

_____, **Member**

_____, **Member**

ATTEST: _____, Secretary