BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
SAN FERNANDO VALLEY FEDERAL)
SAVINGS AND LOAN ASSOCIATION)

Appearances:

For Appellant: Daniel R. Matter and
Don Lidstrom
Certified Public Accountants

For Respondent: Richard A. Watson
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 the San Fernando Valley Federal Savings and Loan Association against a proposed assessment of additional franchise tax in the amount of $23,035.84 for the income year 1970.

The issue presented is whether the Franchise Tax Board abused its discretion in partially disallowing a deduction for an addition to a bad debt reserve, where a portion of the addition was made to decrease a deficit balance in the reserve carried forward from prior years.

The San Fernando Valley Federal Savings and Loan Association, hereinafter referred to as appellant, uses the reserve method of calculating its bad debt deduction. It showed on its books a bad debt reserve of approximately $248; 000 at the beginning of 1968. In that year it sold a tract of property which it had previously obtained in foreclosure proceedings, realizing a loss of over one million dollars. When charged against its bad debt reserve, this loss resulted in what it terms a "debit balance" in the reserve. On its California franchise tax return for the income year 1968, appellant claimed a deduction for an addition to its bad debt reserve sufficient to reduce its taxable income to zero. The addition was not large enough, however, to erase the debit balance.

A similar series of events occurred in 1969.' Appellant suffered a loss of over one million dollars on the sale of foreclosed property, and charged the loss to its bad debt reserve. It then made an addition to the reserve large enough to allpw it to claim a deduction which reduced its taxable income to zero, but which again was not large enough to erase the debit balance.

As a result of these transactions appellant carried forward into 1970 an $852, 054. 00 debit balance in its bad debt reserve. It then claimed a deduction of $492, 966. 00 as an addition to the reserve for that income year. Of this amount $162, 454. 00 was earmarked to provide for estimated future bad debts, and the remaining $330, 512. 00 was intended solely to decrease the debit balance. Respondent determined that this latter portion of the addition was unreasonable and, accordingly, partially disallowed the deduction.

Subdivision (a) of Revenue and Taxation Code section 24348 allows as a deduction, "in the discretion of the. Franchise Tax Board, a

reasonable addition to a reserve for bad debts. " Whilesubject to review, the Franchise Tax Board's determination of the reasonableness of an addition will not be disturbed unless the taxpayer can carry the heavy burden of showing that it was so arbitrary and capricious as to constitute an abuse of-discretion. (Appeals 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.61973; Appeal of Peninsula Savings and Loan Association, Cal. St. Bd.' of Equal. , Jan. 2, 1974.)

Appellant argues that respondent has already fully exercised its discretion by adopting regulation 24348(a), which sets forth guidelines governing additions to the bad debt reserves of savings and loan associations. That regulation states, in relevant part:

> Bad debts may be treated by State or Federal Savings and Loan Associations, hereinafter referred to as associations. . . by a deduction from income of an addition to a reserve for bad debts, see paragraph (3).
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> (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 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 associationchanging to the reserve method in such year (see first year in following computation) and the minimum reserve which an association will be entitled to maintain in future years (see second year in following computation). 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 outstanding 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. (Cal. Admin. Code, tit. 18, reg. 24348(a).)

In essence, appellant's position is that establishing a debit balance in its bad debt reserve was proper because the language of the regulation does not prohibit it. It states that the regulation relates only to the maximum addition an association may make to its reserve and does not contain any reference to a required minimum addition. Since a debit balance is allegedly permitted by the regulation, whose adoption exhausted respondent's discretion in these matters, appellant concludes that respondent cannot forbid the carry-over of its debit balance without amending the regulation.

For the sake of argument, we will assume that respondent cannot deny a bad debt deduction which the association computes exactly in accordance with the regulatory guidelines. It does not follow, however; that respondent has, .in promulgating those guidelines, thereby surrendered its statutory authority to determine the reasonableness of a reserve addition computed in a'manner other than that specifically set forth in the regulation. Although it may be admitted that what appellant did was not expressly prohibited by the regulation, it is clear that appellant did not follow the specific

procedure outlined in paragraph (3) of the regulatibn. If it had, it would have taken deductions in 1968 and 1969 for additions to its reserve sufficient to erase the reserve's debit balance, and there would then have been no occasion for it to claim the portion of the 1970 deduction now at issue. Since appellant's method of adding to its reserve was not explicitly contemplated by the regulation, we believe that whether the addition in question was reasonable was a matter to be decided by the Franchise Tax Board in the exercise of the discretion conferred upon it by section 24348, subdivision (a).

We have concluded that respondent did not abuse its discretion in partially 'disallowing the deduction in question. On the basis of the facts presented to it, respondent decided that it was unreasonable for appellant to make less than the permissible additions to its reserve in the years of loss, and to make up the difference in later years, because the net effect of appellant's action was to charge off net operating losses incurred in 1968 and 1969 against income earned in later years. Appellant argues that failure to permit this result is inequitable since the economic effect of its losses will be felt over a number of years. The fact remains, however, that the Revenue and Taxation Code does not allow net operating loss carry -overs. We cannot find, therefore, that it was arbitrary or capricious for respondent to deny appellant an operating loss carry-over' that is not allowed to any other California taxpayer. Accordingly, we must sustain respondent's action.

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 San Fernando Valley Federal 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 the San Fernando Valley Federal Savings and Loan Association against a proposed assessment of additional franchise tax in the amount of $23,035.84 for the income year 1970, be and the same is hereby sustained.

Done at Sacramento, California, this 18th day of March, 1975, by the State Board of Equalization.

John W. Lynch, Chairman

William M. Bennett, Member

George R. Reilly, Member

Richard Nevins, Member

_____, Member

ATTEST: Charles W. Johnson, Acting Secretary