

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
CALIFORNIA FEDERAL SAVINGS)
AND LOAN ASSOCIATION)

Appearances:

For Appellant: John E. Scheifly
Attorney at Law

Michael I. Blaylock
Attorney at Law

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 California Federal Savings and Loan Association against proposed assessments of additional franchise tax in the amounts of **\$536,101.53** and **\$1,171.68** for the income year 1964.

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Appellant is a federal savings and loan **association that** has elected to use the reserve method of accounting for its bad debts. For the purpose of computing its **allowable loan** loss ratio under respondent's regulation **24348(a)(3)**, appellant made a study of the loan loss experience of itself and its predecessors. during the base period 1928-1947, and concluded that it was entitled to use a loan loss ratio of 2.845 percent. Two of appellant's predecessors were the Railway Mutual Building and **Loan Association** (Railway), which was incorporated. **in** 1927, and First Security Deposit Corporation (First Security)', which was incorporated in 1931 pursuant to a plan to reorganize Railway. Under the reorganization plan,. Railway transferred its delinquent loans 'and foreclosed real estate to First Security on December 28, 1933, for purposes of liquidation. Appellant determined that this transfer gave rise to a loss of \$942,753 which was properly **includible** in the composite **loss experience**.

Upon auditing appellant's loan loss study, respondent found that appellant had erroneously included contracts of sale in loan balances and had treated a net operating loss, a reserve for depreciation, and a loss **on Home Owners'** Loan Corporation bonds as bad debt losses. Respondent disallowed all of these items, as well as the alleged loss arising from the transfer of assets from Railway to First Security, resulting in a downward revision of appellant's loan loss ratio to **.9630** percent. Since appellant's **existing bad** debt reserve already far exceeded the maximum ceiling permitted **by that** ratio, respondent totally disallowed the bad debt deduction appellant had claimed for the year in question. That action led to the deficiency assessments now before us.

Appellant's principal contention, raised for the first time at the protest level, is that First Security's liquidation of the assets received from Railway in **1933** resulted in losses in subsequent years that should be included in the composite loss experience. In the alternative; appellant argues that its loss experience must include the loss realized by Railway on the transfer of assets to First Security.

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Respondent's position with respect to **appellant's** main argument is that appellant has failed to prove that First Security in fact realized any losses on its liquidation of the transferred assets. Under a long established administrative policy and practice, respondent has insisted that savings and loan associations prove the existence of bad debt losses during the base period on a loan **by loan** basis. This policy is necessary, respondent says, because it is the only way respondent can determine whether the association properly accounted for repair expenses, taxes, and depreciation related to property 'acquired by foreclosure. Appellant readily admits that its records are inadequate to establish First Security's alleged bad debt losses on a loan by loan analysis, but it asserts that it can prove by evidence admissible in a court of law the range of losses (from a minimum to a maximum) First Security suffered during 1934 and subsequent years. Since appellant has not **produced its** evidence for examination by respondent **a.** this board, it is impossible to determine the validity of appellant's assertion. In any event, however, we are not persuaded that respondent abused its discretion in requiring proof of losses on a loan by loan basis. A taxpayer seeking to overturn a determination disallowing an addition to a bad debt reserve bears the heavy burden of proving that respondent has acted arbitrarily and capriciously. (Appeal of People's Federal Savings and Loan Association, Cal. St. Bd. of Equal., Feb. 6, 1973; Appeal of San Fernando Valley Federal Savings and Loan Association, Cal. St. Bd. of Equal., March 18, 1975.) No such showing has been made here. Indeed/ it affirmatively appears that there is a sound, rational basis for respondent's administrative policy.

In answer to appellant's alternative argument, that its loss experience should include Railway's loss on the transfer of assets to First Security, respondent contends that Railway's loss may not be measured at some intermediate time between foreclosure and final disposition of the foreclosed property. We agree. In Appeal of People's Federal Savings and Loan Association, supra, we held that when an association has elected to determine its losses on loans secured by real property at the time such property is sold, (see Cal. Admin. Code, tit. 18, reg. 24348(a), subd. (5) (ii), the association cannot later elect to measure its losses at some point between foreclosure and

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final disposition. Appellant and its predecessors, made the election permitted by the regulation, and appellant will not be allowed to renege. **It** does not aid appellant's cause to argue that the transfer of assets must be regarded as a "final" disposition since respondent will not allow it to claim First Security's losses on the disposition of those assets. The answer is, that First Security's losses would be recognized if appellant could produce adequate records to prove the existence of such losses.

Since it has not been shown that respondent acted arbitrarily or capriciously in denying appellant's bad debt deduction, 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,

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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 California Federal Savings and Loan Association against proposed assessments of additional franchise tax in the amounts of **\$536,101.53** and **\$1,171.68** for the income year 1964, be and the same is hereby sustained.

Done at Sacramento, California, this 2nd day of March, 1977, by the State Board of Equalization.

William W. Burroughs, Chairman
Robert E. Kelly, Member
John D. Davis, Member
_____, Member
_____, Member

ATTEST: *W. W. Burroughs*, Executive Secretary