BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 82N-531-MW
BANCAL TRI-STATE CORPORATION)

For Appellant: Eugene F. McKelligan
Vice President
The Bank of California, N.A.

For Respondent: Noel J. Robinson
Counsel

O P I N I O N

This appeal is made pursuant to section 25666[1/] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of BanCal Tri-State Corporation against a proposed assessment of additional franchise tax in the amount of $25,284 for the income year 1975 and pursuant to section 26075, subdivision (a), of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claim of BanCal Tri-State Corporation for refund of franchise tax in the amount of $17,442 for the income year 1976.

1/ Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the income years in issue.

Appeal of BanCal Tri-State Corporation

The question presented by this appeal is whether respondent properly denied appellant's claimed foreign currency exchange losses in computing appellant's unitary business income.

Appellant is a one-bank holding company doing business within and without California. It uses the cash method of accounting, reports its income by a combined report, and determines its income attributable to California by formula apportionment. In 1971, appellant (or one of its subsidiaries) opened an office in London, and, in 1974, one of appellant's subsidiaries opened an office in Tokyo. In reporting its financial condition to appellant, the Tokyo office converted yen to dollars on a monthly basis, In this monthly translation for financial statement purposes, if the yen's position had changed in relation to the dollar, the change in yen necessary to represent the then-current rate was posted as a gain or a loss, depending on whether the yen had weakened or gained in value. This adjustment was made each month even though no specific transaction had occurred involving the asset or liability being valued.

For tax accounting purposes, at year's end appellant totaled the gain and loss accounts, offset losses against gains, and reported the net figure on its California return. For both years on appeal, appellant reported net currency fluctuation losses.

In 1976, appellant applied to the Franchise Tax Board (FTB) for permission to change its method of accounting for determining income or loss from foreign branches. The change requested was apparently from the method described above, a so-called "hybrid net worth" method, to the "net worth" method as described in Revenue Ruling 75-106 (1975-1 C.B. 31). Under the net worth method, noncurrent assets are valued at the currency exchange rates prevailing at the time each such asset was acquired and current assets are valued at the currency exchange rate prevailing at the beginning and the end of the year, whether or not there has been actual conversion to dollars. The FTB (and the Internal Revenue Service) granted permission for the requested change in accounting method and appellant began using the "net worth" method in 1976.

The FTB apparently had a long-standing policy of requiring closed transactions before gain or loss was recognized in connection with foreign currency valuations. In April 1978, this policy was adopted as an

official audit policy. Also in 1978, the FTB prepared a discussion draft of a Proposed Guideline for the Preparation of Combined Reports Which Include Foreign Country Operations, which incorporated the "closed transaction" requirement, and made it available to taxpayers for comment. This proposed guideline was revised in 1979 and 1981, and each time the drafts were submitted to taxpayers for comment. The proposed guideline was never issued as a final official guideline, but was converted into Proposed Regulation 25137(m) in October 1981. Regulation 25137, subdivision (m) was filed on July 7, 1982. (Register 82, No. 28.) This regulation was renumbered as 25137-6 in 1985. (Register 85, No. 13.)

Appellant's 1975 and 1976 returns were audited in 1980, and its currency fluctuation losses were denied in their entirety, apparently because the losses were not the result of "closed transactions" as required by Regulation 25137-6.

Appellant agrees that Regulation 25137-6 should be applied prospectively, but objects to its application to the 1975 and 1976 income years in light of respondent's approval of the net worth method of accounting for 1976.

Under section 26422, the FTB is empowered to prescribe necessary and reasonable regulations to carry out the provisions of the Bank and Corporation Tax Law and "may prescribe the extent, if any, to which any ruling or regulation shall be applied without retroactive effect." (This latter provision is substantially the same as Internal Revenue Code § 7805(b).) Therefore, absent some limitation imposed by statute or regulation, regulations will generally have retroactive effect. (Anderson, Clayton & Co. v. United States, 562 F.2d 972, 979 (1977).) Although this broad authority is reviewable for abuse of discretion, the courts have not often found that such abuse existed. (Security Ben. Life Ins. Co. v. United States, 517 F.Supp. 740, 757 (1980).) It is clear that retroactive application of a regulation is not an abuse of discretion where such application corrects a mistake of law, even though a taxpayer may have relied to his detriment on the mistake. (Dixon v. United States, 381 U.S. 68, 72-73 [14 L.Ed.2d 223] (1965).)

Accounting methods used by taxpayers must clearly reflect income and "if the method used does not clearly reflect income, the computation of income shall be made under such method as, in the opinion of the

Franchise Tax Board does clearly reflect income." (Rev. & Tax. Code § 24651.) The FTB, in promulgating Regulation 25137-6, determined that the method of accounting described in that regulation clearly reflects the income of unitary businesses having foreign country operations. Upon auditing appellant's return, the FTB determined that appellant's method of accounting did not clearly reflect income. The retroactive application of Regulation 25137-6 was the means by which the FTB corrected the mistake of law which it made when it approved appellant's accounting method. Therefore,. respondent properly required appellant to use the accounting method described in Regulation 25137-6 for its foreign operations.

We note, however, that respondent simply denied appellant's loss deductions in their entirety, without attempting to make any computation applying the provisions of Regulation 25137-6. The FTB contends that none of the informationsubmitted at the protest hearing showed any closed transactions. During the protest and negotiation stages, the taxpayer was understandably reluctant to go to the great lengths necessary to retrieve old information before resolution of' the accounting method issue. However, additional requested information was sent to the FTB after the protest hearing. Appellant appears ready to provide any additional information necessary for a computation under Regulation 25137-6. Therefore, we direct the FTB to accept any information which the taxpayer may provide within a reasonable time and, to the extent that the information provided warrants it, recompute appellant's income or loss from its foreign operations using the provisions of Regulation 25137-6.

Appeal of **BanCal** Tri-State Corporation

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 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of **BanCal** Tri-State Corporation against a proposed assessment of additional franchise tax in the amount of $25,284 for the income year 1975, and pursuant to section 26077 of the Revenue **and** Taxation Code, that the action of the Franchise Tax Board in denying the claim of **BanCal** Tri-State Corporation for refund of franchise tax in the amount of $17,442 for the income year 1976, be modified in accordance with the foregoing opinion.

Done at Sacramento, California, this 4th day of March , 1986, by the State Board of Equalization, with Board Members Mr. **Nevins**, Mr. Collis, Mr. Dronenburg and Mr. **Harvey** present.

Richard Nevins, Chairman

Conway H. Collis, Member

Ernest **J. Dronenburg, Jr.**, Member

Walter **Harvey*** , Member

_____ Member

*For Kenneth Cory, per Government Code section **7.9**

BEFORE THE STATE BOARD OF EQUALIZATION

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In the Matter of the Appeal of)
) NO. 82N-531-MW
BANCAL TRI-STATE CORPORATION)

ORDER DENYING PETITION FOR REHEARING. AND MODIFYING OPINION

Upon consideration of the petition filed March 25, 1986, by BanCal Tri-State Corporation for rehearing of its appeal from the action of the Franchise Tax Board, we are of the opinion that none of tne grounds set forth in the petition constitute cause for the granting thereof and, accordingly, it is hereby ordered that the petition be and the same is hereby denied and that our order of March 4, 1986, be and the same is hereby affirmed.

For good cause appearing therefor, it is also hereby ordered that our opinion of March 4, 1986, be and the same is hereby modified by deleting the paragraph that **begins at the bottom of the third page of the opinion and continues on to the fourth** page of the opinion and replacing it with:

> Accounting methods used by taxpayers must clearly reflect income and "if the method used does not clearly reflect income, the computation of income shall be made under such method as, in the opinion of the Franchise Tax Board, does clearly reflect income." (Rev. & Tax. Code § 24651.) The FTB, at least as early as 1978, determined that the method of accounting *now* embodied in Regulation 25137-6 clearly reflects the income of unitary businesses having foreign country operations. upon auditing appellant's return, the FTB determined that appellant's method of accounting did not clearly reflect income. The application of the method

of accounting now embodied in Regulation 25137-6 was the means by which the FTB corrected the mistake of law which it made when it approved appellant's accounting method. Therefore, the FTB properly required appellant to use the accounting method described in Regulation 25137-6 for its foreign operations.

Done at Sacramento, California, this **10th** day of June, 1986, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. **Collis,** Mr. Bennett, Mr. Dronenburg and Mr. Harvey present.

Richard Nevins, Chairman

Conway H. Collis, Member

William M. Bennett, Member

Ernest J. Dronenburg, Jr., Member

Walter Harvey*, Member

*For Kenneth Cory, per Government Code section 7.9