BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 84A-397-MA
HOME BUDGET LOANS)

Appearances:

For Appellant: Stanley Zimmerman
President

For Respondent: Grace Lawson
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 Home Budget Loans against proposed assessments of additional franchise tax in the amounts of $3,919, $4,521, and $12,525 for the income years 1978, 1979, and 1980, respectively.

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 Home **Budget Loans**

The sole issue in this appeal is whether appellant is entitled to a deduction for additions made to a "statutory guarantee" account required by the Department of Real Estate.

Appellant is a California corporation which reports its income on an accrual basis. During the years at issue, appellant's business included mortgage brokerage services. In this capacity, it receives a fee for locating lenders willing to dispense funds secured by second or third deeds of trust. To facilitate the **lender-**borrower transaction, appellant acted as guarantor of the underlying debt.

As a result of its mortgage brokerage business, the Department of Real Estate (DRE) determined that **appellant** was a real property securities dealer and required it to obtain a department permit as required by Business and Professions Code sections 10237 and **10238.3.** The DRE required appellant to deposit an amount equal to five percent of outstanding debts guaranteed by appellant in a statutory reserve account established with the Treasurer **of** the State of California. For the years at issue, appellant met this requirement by depositing letters of credit, issued by the Bank of America, which were conditioned upon appellant meeting certain accounting requirements and establishing a "reserve of loan guarantee" (also termed a loan guarantee reserve). In taxable years 1978, 1979, 1980, these letters extended credit to appellant in the amount of $300,000, $300,000, and $400,000, respectively. In 1979, the bank required appellant to establish a loan guarantee reserve in the minimum amount **of** $38,000. The record does not indicate the minimum reserve balance for the tax years 1978 or 1980.

As the guaranteed debt was paid, proportionate amounts of the funds deposited in the loan guarantee reserve were freed. On its tax returns for the years at issue, appellant took a bad debt deduction relative to its lending business. For years 1978, 1979, and 1980, it also took bad debt deductions in amounts totalling $40,509, $47,274, and $126,702,. respectively, representing additions to its "statutory guarantee" account. Following an audit, respondent disallowed the deductions and appellant protested. This timely appeal followed.

Generally, under both federal and state law and regulations, a taxpayer is required to elect one of two bad debt deduction methods, the specific charge-off method or an addition to a bad debt reserve, as its treatment of

bad debts. (Treas. Reg. § 1.166-1(b)(1) (1983); Rev. & Tax. Code, § 24348.) However, in very limited situations involving a taxpayer who is a dealer in property, the taxpayer may take a deduction for reasonable additions to a reserve for bad debts which arise from its contingent liability as a guarantor, endorser, or indemnitor of debt obligations arising out of the sale by it of real property or tangible personal property (including related services) in the ordinary course of the dealer's business. This reserve can be in addition to a reserve for bad debts for accounts receivable arising from transactions which do not involve the taxpayer being a guarantor, endorser, or indemnitor. Thus, a taxpayer qualifying under section 24348, subdivision (b), may also maintain a reserve under section 24348(a) electing either the direct charge-off or reserve method. (See generally SR No. 1710, 1966 U.S. Code Cong. & Ad. News 3764.)

Appellant argues that it is not foreclosed from claiming its additions to its statutory guarantee account as additions to a bad debt reserve because the reserve in question is a reserve for bad debts which may arise out of a taxpayer's liability as a guarantor under section 24348, subdivision (b), as detailed above. Appellant contends it comes within the provisions of section 24348, subdivision (b), in that it is a dealer in property and its liability as a guarantor arose out of the sale by it of real property (including related services) in the ordinary course of, its business. Appellant contends that its sale of trust deeds unquestionably is a "related service" to the sale of real estate and section 24348, subdivision (b) clearly permits an additional reserve method for bad debts arising from the guarantee of debt obligations resulting from services related to the sale of property. In support of its contentions, appellant argues that it is a dealer in property because it does more than merely try to bring a lender and borrower together: in effect, it commits to a loan, advances funds, takes a deed of trust and sells that deed of trust to an assignee-lender. At the hearing on this matter, appellant requested that we take note of the definitions found in the Business Professions Code of the terms "Broker," "In the Business," and "Real Property Security," (see generally Bus. & Prof. Code §§ 10131.1 and 10237.1) as another indication of its involvement in the sale of real property including related services.

Appellant also argues that even though it had no actual losses, the reserve was proper as a reserve for bad debts which may arise out of a taxpayer's liability

as a guarantor and the amount of the reserve was reasonable because it was dictated by DRE requirements. It cites Mitchell Huron Production Credit-Ass'n. v. Welsh, 163 F.Supp. 883 (D.C.S.D. 1958), as support of the proposition that because the amount of the statutory guarantee account was set by DRE it was per se reasonable.

Although we agree with appellant's contention that if its reserve is a reserve for bad debts which may arise out of taxpayer's liability as a guarantor under section 24348, subdivision (b), it is not foreclosed from claiming the additions, we do not agree that appellant qualifies as a guarantor under that subdivision. Appellant has incorrectly interpreted the term "related services" as it appears in section 24348, subdivision (b). For guidance in interpreting this phrase, we turn to the resort of the U.S. Senate Finance Committee (SR Rep. No. 1710) following the passage of P.L. 89-722 which added a similar provision to the Internal Revenue Code (I.R.C. § 166, subd. (g).) The exclusivity of the special provisions for a bad debt reserve to sellers of real or tangible personal property is made clear in the following statement:

> This bad debt reserve may be attributable to the sale by the taxpayer of either real property or tangible personal property and services related to these properties. The debt need not initially be the debt owing to the taxpayer as long as it arises from the sale by him of the property and he is guaranteeing payment. (Emphasis added.)

(1966 U.S. Code Cong. & Ad. News 3767.)

The fact that an actual sale of property by the taxpayer-guarantor must occur was emphasized in Colter v. Commissioner, ¶ 73,215 T.C.M. (P-H) (1973), in which the court held that "a deduction (under I.R.C. section 166(g)) was not allowable for additions to the reserve for bad debts on account of obligations with respect to which the taxpayer was merely a guarantor, endorser, or indemnitor because such obligations did not arise out of the sale of real or tangible personal property by the taxpayer." (See also, Budget Credits, Inc. v. Commissioner, 50 T.C. 52 (1968) aff'd per curiam 417 F.2d 1108 (6th Cir. 1969).) It is clear that this section "requires that the taxpayer-guarantor be 'a dealer in property' and that the obligations be those 'arising out of the sale by him of real

property or tangible personal property."' (Budget Credits, Inc. v. Commissioner, supra, at 52 T.C. 56.)

Appellant has attempted to place itself within the provisions of section 24348, subdivision (b), on the basis that it is involved in services related to the sale of property by a seller other than itself. We do not agree with this interpretation. Appellant's business is mortgage brokerage. It receives a fee for locating lenders willing to dispense funds secured by second or third deeds of trust. In each situation it acts solely as a guarantor. Although for purposes of the DRE statutes and regulations, appellant may be considered a real estate broker, such activity is not sufficient to meet the conditions prescribed in section 24348, subdivision (b), for the allowance of a reserve on account of such obligations in that the obligations did not arise out of the actual sale of real or tangible personal property by appellant. (Colter v. Commissioner, supra.) As such, we must conclude that appellant cannot treat the additions to its statutory guarantee account as additions to a bad debt reserve pursuant to section 24348, subdivision (b).

Our inquiry does not end here. Appellant has also put forth the alternative argument that the additions to its statutory guarantee account qualified as additions to its reserve for bad debts under section 24348, subdivision (a). During the years at issue, appellant advanced commissions to its sales people and salaries to its employees for emergencies. In addition, in some cases, a borrower was unable to pay a loan fee and it was paid by appellant. Some of these items of compensation were not recouped and were written off by appellant. These amounts totalling $6,521 in 1978, $13,807 in 1979, and $2,930 in 1980 were deducted on appellant's tax returns as bad debts by means of the specific charge-off method. By this action, appellant made an implied election to select the specific charge-off method as its treatment of its bad debts under section 24348, subdivison (a). Respondent has no record of appellant requesting or obtaining the required permission to change to the reserve method provided under section 24348, subdivison (a), which is required once an election has been made. Appellant's contentions that the claimed deductions using the special charge-off method was erroneously reported and that it intended to report on the reserve method is without merit, especially in light of the fact that it utilized the same method for all of the years at issue. Therefore, we must conclude that during the years at issue, respondent utilized the

specific charge-off method as its treatment of bad debts under section 24348, subdivision (a), and is foreclosed from simultaneously using the reserve method provided for in that section. (See Appeal of Harrison Pontiac Co., Cal. St. Bd. of Equal., May 29, 1952.)

Finally, we note in passing that the claimed additions to appellant's statutory guarantee account do not qualify as business expense deductions under section 24343. It is well settled that a taxpayer may deduct '"all of the ordinary and necessary expenses paid or incurred ... in carrying on any trade or business." Appellant's statutory guarantee account consisted of letters of credit secured by funds set aside in a bank-required loan guarantee reserve. The underlying funds in the loan reserve account remained appellant's property. As such, there was no expense "paid or incurred" and, therefore, we must conclude that the additions did not qualify as business expense deductions.

For the reasons set forth above, respondent's action in this matter is 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 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Home Budget Loans against proposed assessments of additional franchise tax in the amounts of $3,919, $4,521, and $12,525 for the income years 1978, 1979, and 1980, respectively, be and the same is hereby sustained.

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