BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 81R-1284-VN
CENTRAL FEDERAL SAVINGS AND)
LOAN ASSOCIATION OF SAN DIEGO)

For Appeilant: J. Mark Warner
Arthur Young and Company

For Respondent: Karl Munz
Counsel

O P I N I O N

This appeal is made pursuant to section 26075, subdivision (a),[1/] of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claims of Central Federal Savings and Loan Association of San Diego for refund of franchise tax in the amounts of $14,661, $153,327, and $116,327 for the income years 1976, 1977, and 1978, 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.

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The issue presented for our resolution is whether respondent properly determined that appellant's change in its method of computing income from loan fees was a change in accounting method requiring prior consent of the Franchise Tax Board.

Appellant is a federal savings and loan association supervised by the Federal Home Loan Bank Board. Its principal business is the making of loans for the purchase or construction of commercial and residential real estate. The loans are secured by deeds of trust on the subject realty. In addition to interest, appellant earns income from a loan by charging a loan fee to the borrower. As a matter of practice, appellant apparently adds the amount of the loan fee to the promissory note and disburses proceeds to the borrower in an amount equal to the difference between the loan Lee and the face amount of the note. In other words, the loan is discounted as the loan iee is deducted from the full amount of the loan when it is made.

In 1968, appellant requested and received permission from the Franchise Tax Board to report its income from loan fees under the "liquidation method" as set forth in Revenue Ruling 64-278, 1964-2 C.B. 120:

> Under the "liquidation method" of accounting a bank or similar taxpayer, using the cash receipts and disbursements method of accounting, determines the amount of interest received from loans made at a discount by applying the percentage that the amount of loan principal liquidated during each month bears to the total loan principal outstanding at the beginning of the month to the unearned interest applicable to such loans. This method is illustrated by the following example:
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> > Example: At the beginning of the month Y had outstanding loans of 500x dollars and unearned discount of 50x dollars. During the month, 100x dollars of the loans which were outstanding at the beginning of the month were liquidated, making the percentage of liquidation 20 percent, This percentage, applied to the unearned interest of 50x dollars, results in 10x dollars of earned

interest being realized for the month.

Under this method of accounting, a cash-basis lender is thus allowed to defer reporting of loan fee income from loans made at a discount by effectively apportioning said income over the terms of the loans on a straight line basis as payments are made on the notes. (See Rev. Rul. 72-100, 1972-t C.B. 122,123).

After *using the* liquidation method through the years under review, appellant changed its method of accounting for loan fees derived from loans that were subsequently sold to other lending institutions and buyers of discount loans. Appellant calculated that, for each discount loan sold at the face amount of the attendant promissory note, it realized gain equal to tne uncollected portion of the loan fee since the adjusted basis of the loan was set at i.ts face amount Less the loan fee. Apellant was able to compute the amount of the loan fees that it had yet to earn at the time of sale. Appellant then treated the loan fees from loans sold as income in the year in which the loans were sold rather than reporting the fees under the liquidation method. As a result of this change in accounting for loan fees from loans sold, appellant computed that it had reported excessive loan fee income for the three income years under review and filed claims for refund. The Franchise Tax Board denied the refund claims based on its determination that appellant hdd'changed its method of accounting without respondent's prior consent,

Section 24651, subdivision (e), expressly provides that a taxpayer who changes the method af accounting used in keeping its books shall secure the consent of the Franchise Tax Board before computing its income upon the new method. (See Cal, Admin. Code, tit, 18, reg. 24651, subdivision (e), for procedural requirements to change method of accounting.) This section is derived from and is substantially the same as Internal Revenue Code section 446(e), which requires the consent of the Commissioner for a change in accounting methods.. Federal. precedent is therefore persuasi've of the proper interpretation of section 24651. (Meanley v. McColgan, 49 Cal.App.2d 203 [121 P.2d 45] (1942).)

A taxpayer may change the met-hod of accounting' by which it regularly computes i-ts taxable income only upon proper application and approval. of the change by the taxing agency. (Thompson-King-Tate, Inc. v. United

States, 296 F.2d 290 (6th Cir. 1961); Arthur L. Kniffen v. Commissioner, 39 T.C. 553 (1962); Ben W. Sartor v. Commissioner, ¶ 77,327 T.C.M. (P-H) (1977).) The purpose of the consent requirement is twofold: (1) to prevent distortions of income that often accompany changes in accounting methods by giving the Commissioner an opportunity to review proposed changes in accounting methods; and (2) to promote year-to-year consistency in accounting practices in order to facilitate uniformity in the tax collection process. (Witte v. Commissioner, 513 F.2d 391 (D.C. Cir. 1975); Poorbaugh v. United States, 423 F.2d 157 (3d Cir. 1970).) A taxpayer must obtain consent to change to a new method of accounting regardless. of whether or not such method is proper or is permitted under the Internal Revenue Code or the regulations thereunder. (Treas. Reg. § 1.446-1(e)(2)(i).) In the event that a taxpayer does change from its previously established method of accounting without permission, the change will be invalid for tax purposes (Boudrow v. United States, 44 A.F.T.R. 2d (P-E) § 79-5036 7979); Appeal of First Federal Savings and Loan Association of San Diego, Cal. St. Bd. of Equal., Feb. 18, 1964), and the administering agency may ignore the attempted change by computing the income of the taxpayer under its established method (see United States v. Kleifgen, 557 F.2.d.1293 (9th Cir. 1977); Wilson Chemical Co., Inc. v. Commissioner, ¶ 70,004 T.C.M. (P-H) (1970).)

First, Treasury Regulation 1.446-1(e)(2)(ii)(a) provides that a-change in method of accounting includes a change in the overall plan of accounting for income or deductions or a change in the treatment of any material item used in an overall plan. A material item is defined as any item that involves the proper time for the inclusion of the item in income or the taking of a deduction. In the present matter, appellant's change from the liquidation method to an ostensibly cash receipts method for accounting for loan fees earned from loans sold constituted a change in the treatment of a material item, Under the liquidation method, appellant was required to report the loan fees ratably as payments were made by borrowers; The amount of income therefrom was determined based on the aggregate percentage of liquidation for all its loans. Under its revised method, appellant apparently continued employing the liquidation method until it sold a discount loan. At such time, appellant removed the sold loan from the liquidation formula and included the loan fees received from the sale in gross income in the year of sale, Whereas the amount of loan

fee income includible in appellant's gross income would not be the same for a given time period under the two methods, it is our view that appellant's change in the way it calculated loan fees from loans sold involved the proper timing for inclusion of such loan fees in appellant's income. As such, it was a change in the treatment of a material item, resulting in a change in accounting methods. (See Rev, Rul. 79-378, 1979-2 C.B. 201; Connors, Inc. v. Commissioner, 71 T-C. 953, 919 (1979).)

Second, federal regulations further provide that a consistent method of reporting interest from installment loans made at discount is considered a method of accounting which a taxpayer may not change without first obtaining the permission of the Commissioner. (Rev, Rul. 72-100, supra, 1972-1 C.B. at 123; see also Treas. Reg. § 1.446-1(e)(2)(ii) (a).) Here, appellant's separate procedure for accounting for loan fees upon the sale of discount loans is not at all consistent with the liquidation method approved earlier by respondent. Appellant's revised method recognizes loan fees immediately upon sale of an individual discount loan whereas the liquidation formula allows deferral of loan fee income based on the liquidation percentage of all existing loans. In support of its position. appellant has contended merely that section 24901 required reduction of the basis of the loans sold by the amount of the unearned loan fees in order to determine gain or loss. 'Even assuming that the unearned loan fees were. a necessary component in the calculation of basis, appellant has not provided any arguments or authority addressing the issue whether or not its method effected a change in its method of accounting for loan fees.

Based on the record in this appeal, we find that appellant changed its method of accounting for loan fees without the prior consent of the Franchise Tax Board. Accordingly, respondent's action in denying appellant's claims for refund must be sustained,

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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 26077 of the Revenue and Taxation Code, that the action of the Franchise Tax Boardin denying the claims of Central Federal Savings and Loan Association of San Diego for refund of franchise tax in the amounts of $14,661, $153,327, and $116,327 for the income years 1976, 1977, and 1978, be and the same is hereby sustained,

Done at Sacramento, California, this 19th day Of November , 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 Kenenth Cory, per Government/ Code section 7.9