87-SBE-027

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

in the Matter of the Appeal of	)	
	)	No. 85R-534-VN
CENTER STATE BANK	)	

For Appellant: Jeffrey A. Bertleson
Certified Public Accountant

Pot Respondent: Anna Jovanovich
Counsel

OPINION

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 claim of Center State Bank for refund of franchise tax in the amount of $33,618 for the income year ended June 30, 1982.

[1] Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the year in issue.

Appeal of Center State Bank

The sole issue presented for our decision is whether appellant was entitled to retroactively increase an addition to its bad-debt reserve.

Appellant, which is engaged in the business of banking in the Modesto area, has elected the reserve method of accounting for its bad debts. On its franchise tax return for the income year ended June 30, 1982, appellant reported taxable income of $291,553 and claimed a deduction for a $245,078 addition to its bad-debt reserve. Appellant apparently entered this addition on its reserve accounts and financial records.

Sometime during the summer of 1982, the Federal Deposit Insurance Corporation (FDIC) began an examination of appellant's financial condition. On August 27, 1982, the FDIC issued a highly critical examination report in which it outlined numerous unsatisfactory conditions and poor business practices that were found to exist in appellant's bank operations. Among its specific charges, the FDIC found that appellant had failed to properly classify $1,270,381 in uncollectible loans as losses on its books and records. On November 26, 1982, appellant's board of directors held a special meeting to discuss the FDIC report. With regard to the loans deemed uncollectible by the FDIC, the board decided to eliminate them from appellant's loan portfolio and add their corresponding amounts to its bad-debt reserve.

Eight months later, on July 26, 1983, appellant filed an amended return for its 1982 income year claiming an additional deduction of $291,555 for an increased addition to its reserve for bad debts. Upon review of the resultant claim for refund, the Franchise Tax Board disallowed the increased addition on the basis that it was an improper retroactive addition to the bad-debt reserve. Consequently, respondent denied the refund claim and this appeal followed.

Section 24348 allows a deduction for a reasonable addition to a reserve for bad debts in lieu of a deduction of a specific debt that becomes worthless within the income year. This section provides that, if a taxpayer elects to employ the reserve method of accounting for its bad debts instead of the specific charge-off method, any addition claimed will be subject to the discretion of the Franchise Tax Board. Internal Revenue Code section 166, the federal counterpart to section 24348, vests the same discretion in the Commissioner of Internal Revenue to determine the reasonableness of a

federal taxpayer's addition to its reserve for bad debts, because of the substantial similarity between the two sections, federal precedent is persuasive of the proper interpretation of the California statute. (Meanley v. McColgan, 49 Cal.App.2d 203 [121 P.2d 45] (1942).)

In general, a reserve for bad debts represents merely an estimate of future losses which have not accrued but can reasonably be expected to be sustained from obligations outstanding at the close of the income year. (Valmont Industries, Inc. v. Commissioner, 73 T.C. 1039 (1980); Handelman v. Commissioner, 36 T.C. 560 (1961).) Under the reserve method, for handling bad debts, the reserve is reduced by charging against it specific bad debts which become worthless during the income year and is increased by crediting it with *reasonable* additions which are deductible. (Roanoke Vending Exchange, Inc. v. Commissioner, 40 T.C. 735 (1963).) What constitutes a reasonable addition is a factual matter depending upon conditions of business prosperity, the total amount of debts outstanding at the end of the year, including current debts as well as those of prior years, and the total amount of the existing reserve. (Treas. Reg. § 1.166-4(b)(1); Mills & Lupton Supply Company, Inc. v. Commissioner, ¶ 77,294 T.C.M. (P-H) (1977).)

A basic requirement for an addition to a bad-debt reserve is that the addition must reflect conditions existing at the end of the income year in question. (Roanoke Vending Exchange, Inc. v. Commissioner, supra; Treas. Reg. § 1.166-4(b)(1).) The actual-loss experience of a taxpayer in years subsequent to the income year may be used as additional evidence to confirm the reasonableness of its method of computing the claimed addition to the reserve. (Roanoke Vending Exchange, Inc. v. Commissioner, supra.; Massachusetts Business Development Corp. v. Commissioner, 52 T.C. 946 (1969).) However, it is well settled that a taxpayer may not retroactively increase an addition for a prior *year* based on subsequent events that reveal the reserve to be insufficient. (Farmville Oil & Fertilizer Co. v. Commissioner, 78 F.2d 83, 84-85 (4th Cir. 1935); Appeal of Leight Sales Co., Inc., and G.L. Company, Inc., Cal. St. Bd. of Equal., June 29, 1982.) Where its reserve later proves to be inadequate, the taxpayer may instead correct its error in judgment by determining a reasonable addition that reflects the *necessary* adjustment in the current income year. (Treas. Reg. § 1.166-4(b)(2); Appeal of Sun Valley

National Bank of Los Angeles, Cal. St. Bd. of Equal., Jan. 12, 1965.)

Respondent's determination with regard to an addition to a reserve for bad debts carries a great deal of weight due to the discretion granted to it by statute. Accordingly, a taxpayer who challenges a disallowance of a claimed addition faces a greater burden of *proof* than the usual burden facing one who seeks to overcome the presumption of correctness attached to- respondent's deficiency assessments. (Roanoke Vending Exchange, Inc. v. Commissioner, supra, 40 T.C. at 741; James A. Messer Co. v. Commissioner, 57 T.C. 848 (1972).) The taxpayer is required not only to demonstrate that its claimed addition to the reserve was reasonable, but it must also establish that respondent's action in disallowing the claimed addition was arbitrary and amounted to an abuse of discretion. (Thor Power Tool Co. v. Commissioner, 439 U.S. 522 [58 L. Ed.2d 785] (1979); Westchester Development Co; v. Commissioner, 63 T.C. 798 (1974); Appeal of Vaughn F. and Betty F. Fisher, Cal. St. Bd. of Equal., Jan. 7, 1975.)

In the instant matter, there is no evidence in the record, that the Franchise Tax Board has contested the reasonableness of the addition claimed by appellant in its amended return for 1982. To prevail in this appeal, appellant must, however, establish that respondent abused its discretion in disallowing the claimed addition.

At the outset, appellant contends that it computed the original addition to its bad-debt reserve under the experience method but amended its return to reflect calculation of an increased addition using the . f acts and circumstances" method, Appellant then argues that retroactive changes in a reserve for bad debts are allowed under Revenue Ruling 75-445, 1975-2 C.B. 74, when changing methods of computing a reasonable addition.. Appellant's argument is meritless. First, appellant has not provided any explanations of his facts-and-circumstances method to enable us to determine whether it is a permissible method under California law by which a bank can compute a reasonable addition to its bad-debt reserve. (See former Cal. Admin. Code, tit. 18, reg. 24348(b), subd. (3)(A).) Nor has appellant presented any calculations to convince us that its increased addition was, in fact, a result of a change in methods of computing an addition to its bad-debt reserve rather than a retroactive addition made in response to the PDIC report. Second, Revenue Ruling 75-445 does not state that

retroactive changes in a bad-debt reserve- are allowable when changing methods of computing a reasonable addition. It simply provides that a bank which computes its additions using either the percentage or the experience method under, section 585(b) of the Internal Revenue Code. may amend its return to change from one method to the other. Because banks. have the option under section 585(b) *to* choose either method, neither of which is considered a method of accounting, Revenue Ruling 75-445 posits that the change from the percentage to the experience method, or visa versa, is not a change in the method of accounting.

Furthermore, appellant asserts that its orginal addition was inadequate, for it failed to properly reflect the condition of its loan portfolio as of the end of the income year in question. It is appellant's contention that regulation 24348(b), subdivision (3)(A)(ii), requires a bank's bad-debt reserve to reflect the true condition of its loan portfolio and permits subsequent adjustments to a reserve which may exceed the original. addition entered on the bank's financial accounts and records. We disagree. Regulation 24348, subdivision (3)(A) (ii), simply allows a bank an addition greater than provided under the six-year experience method of subdivision (3)(A)(i) if it can show higher anticipated losses for loans based on the condition of its loan portfolio as of the close of the income- year. This regulation does not mandate that a bank's addition or its reserve reflect the condition of its loan portfolio. Nor does it allow a retroactive addition where, as it appears in this appeal, a bank has merely discovered that its original addition was insufficient.

As a rule, a taxpayer is permitted a reasonable time after the close of its income year to audit *its* books and adjust the entries to its reserve accounts. (See Rio Grande Building & Loan Association v. Commissioner, 36 T.C. 657, 664-665 (1961).) Once it has determined a reasonable addition on the basis of its bookkeeping entries, the taxpayer will not be allowed to retroactively change its determination and enlarge its reserve even though the increased addition is reasonable. (Rio Grande Building & Loan Association v. Commissioner, supra; Rogan v. Commercial Discount Co., 149 F.2d 585 (9th Cir. 1945).) In Appeal of Foothill Bank, decided on June 27, 1984, this board did allow a taxpayer to subsequently correct an original addition after the State Banking Department directed an increase in its reserve

account. The taxpayer in that appeal had filed its return before it was able to make the final adjustments in its books, but it then claimed the additional amount by filing an amended return within two months after it had made the required bad-debt reserve adjustments in its financial statements for the income year. The present appeal is clearly distinguishable, for the record indicates appellant estimated *an* addition and entered said addition on its books of account. Appellant did not attempt to enlarge the addition until one year after the FDIC had found its reserve to be inadequate and does not contend that the increased addition was a corrective measure reflecting the changes in its books and financial statements dictated by the FDIC examination of its loan portfolio and reserve accounts. Rather, appellant contends that the increased addition was a result of a *change* in accounting methods.

Based on the *foregoing, we* find that appellant has failed to carry its burden of showiag that respondent's disallowance was arbitrary and amounted to an abuse of discretion. Accordingly, respondent's action in this matter will be sustained.

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ORDER

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 Board in denying the claim of Center State Bank for refund of franchise tax in the amount $33,618 of for the **income** year ended June 30, 1982, **be** and the same is hereby sustained.

Done at **Sacramento, California,** this 7th **day of** April , 1987, by the State Board of Equalization, **with** Board **Members** Mr. **Collis,** Mr. **Dronenburg,** Mr. **Carpenter** and **Ms.** Baker present.

Conway H. Collis, Chairman

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

Paul Carpenter, **Member**

Anne Baker*, **Member**

, **Member**

*For Gray Davis, per Government Code section 7.9