

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
San Francisco Police Credit Union) No. 96A-0656
)
)

Representing the Parties:

For Appellant: JoAn Blackstone, Attorney
Randy Moore, Attorney

For Respondent: Edward J. Kline, Counsel

Counsel for Board of Equalization: Derick J. Brannan, Tax Counsel

OPINION

This appeal is made pursuant to section 19045 of the Revenue and Taxation Code¹ from the action of the Franchise Tax Board on the protest of the San Francisco Police Credit Union

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

against proposed assessments² of additional franchise tax in the amounts of \$57, \$19,466, and \$63,548,³ for the income years ended December 31, 1988, December 31, 1989, and December 31, 1990, respectively.

Appellant is a member-owned credit union subject to the terms of section 24405, subdivision (c), effective beginning with the first income year on appeal. In general terms, subdivision (c) allows for the deduction of income arising from the investment of a credit union's member savings capital to the extent those funds are not used for loans to credit union members; more succinctly, income from invested Surplus Member Savings Capital (SMSC) is deductible income. The parties dispute the proper determination of SMSC for purposes of calculating the deduction allowed by subdivision (c).

Appellant timely filed its state tax returns for each of the subject income years. On each of those returns, appellant deducted income which it attributed to SMSC. In computing those deductions, appellant made a number of assumptions about the manner in which section 24405, subdivision (c), was to be implemented. On or about September 25, 1992, after appellant filed those returns, respondent published Franchise Tax Board Notice 92-7 (Notice 92-7) which set forth respondent's methodology for determining the deduction allowed by subdivision (c). Appellant agrees that it did not properly determine its subdivision (c) deductions when it filed its original returns. Appellant also agrees in principle with the procedure set forth in Notice 92-7. However, appellant does not agree with the manner in which respondent implemented the terms of Notice 92-7 in arriving at the assessments at issue on appeal.

In pertinent part, section 24405 provides as follows:

“(a) In the case of [a credit union], all income resulting from or arising out of business activities for or with their members carried on by them or their agents, or when done on a nonprofit basis for or with nonmembers, shall be an allowable deduction.

* * *

“(c) For the purposes of subdivision (a), a credit union's activities are 'for or with' the members of the credit union if the activities involve the

²Appellant paid these amounts pending this appeal, and therefore, the appeal became an appeal from the denial of claims for refund pursuant to Revenue and Taxation Code section 19335.

³Respondent concedes that appellant is due a refund of \$37,781 plus interest for the 1990 income year due to an adjustment in the amount of appellant's other nonmember income for that year.

investment of surplus member savings capital ... ‘Surplus member savings capital’ means the savings capital of credit union members which is in excess of the amount of savings capital which is loaned to members of the credit union. The term ‘savings capital’ shall have the meaning set forth in subdivision (a) of Section 14400 of the Financial Code.

“(d) For purposes of subdivision (a), ‘income resulting from or arising out of business activities for or with their members’ includes, but is not limited to, all income resulting from reciprocal transactions with member credit unions.”⁴

(Emphasis added.) California Finance Code section 14400 reads as follows:

“(a) The [member] savings capital of a credit union shall consist of the payments made by members on shares ...

“(b) The equity capital of the credit union shall consist of all consideration paid for memberships in the credit union, all entrance fees paid to become a member of a credit union, all moneys held in the credit union’s regular reserve account, all dues, fees, and assessments paid by credit union members, other than fees charged in connection with member share accounts or loans, and held in any contingency reserve account established by the credit union’s board of directors or at the direction of the commissioner, and all retained earnings in the credit union’s undivided profits less all losses in excess of the credit union’s regular reserve account.”

(Emphasis added.)

Prior to the enactment of section 24405, subdivision (c), credit union deductions of income were limited to that income arising from business activities for or with credit union members as described in subdivision (a) of that section. Taxpayers determined the amount of their subdivision (a)

⁴ The legislature enacted section 24405, subdivision (d), for income years beginning on or after January 1, 1993. Although not effective for the income years on appeal in the instant case, it does help illustrate the issues currently on appeal.

deductions based on the source of income as identified from traditional accounting records. The enactment of subdivision (c) established a new type of deduction for credit unions based on the source of funds used to generate the subject income, i.e., SMSC. The implementation of these two distinct deductions gives rise to two basic problems, both of which must be addressed in the instant case. First, because money is generally a fungible commodity and because traditional accounting methods do not generally trace the source of funds used to fund certain investments, respondent must use some formula to approximate the income generated by SMSC.⁵ Second, because SMSC might be used to generate income which is also deductible under subdivision (a) or (d), the resulting formula must somehow reconcile these competing and/or overlapping deductions.

Notice 92-7 sets forth a two part formula (the formula) for determining the amount of income attributable to SMSC. First, the formula determines a percentage figure designed to reflect the percentage of total investment income attributable to SMSC (the allocation percentage). Notice 92-7 indicates that the amount of SMSC shall be divided by the sum of appellant's SMSC and Equity Capital⁶ to produce an allocation percentage; that percentage should represent the portion of the taxpayer's total investment income which may be deducted because it arose from SMSC. Second, the allocation percentage is applied to the taxpayer's investment income to produce the proper amount of deductible income.⁷ Appellant agrees with the basic formula as set forth in Notice 92-7.

Appellant disagrees with the manner in which respondent derived the factors used in the formula.⁸ Respondent used the average of the beginning and end of year figures for both the SMSC and equity capital used to calculate the allocation percentage. Further, respondent also determined the amount of SMSC used to compute the allocation percentage by subtracting both member loans and the

⁵If the taxpayer or respondent can trace the use of certain funds to a specific investment, a formula may not be necessary. Both Notice 92-7 and this opinion allow for that possibility. (See generally Appeal of Zenith National Insurance Corp., 98-SBE-001, Jan. 8, 1998.) However, the instant case does not involve tracing, and therefore, we need not discuss that issue at this time.

⁶Equity capital shall be determined in accordance with the definition set forth at Financial Code section 14400, subdivision (b), supra.

⁷Appellant and respondent had initially disagreed as to the composition of that income subject to the allocation percentage. However, in light of our determination as to the proper derivation of SMSC, the dispute is moot. In short, whether income from member transactions is attributable to SMSC or equity capital based on the formula, the income will still constitute deductible income pursuant to section 24405, subdivision (a) or (d).

⁸Prior to the hearing, appellant argued that the formula should allow for some adjustment based on those assets which, by their nature, could not generate income properly subject to the formula. Appellant abandoned that position at the hearing apparently on the basis that such assets will generally be funded from SMSC and equity capital in the same proportion as any other income subject to the formula. Hence, no further adjustment to the formula is necessary.

amount of any transactions with member credit unions from appellant's member savings capital (member deposits).

With regard to respondent's use of average figures for SMSC and equity capital in the formula, both parties agreed that the average figures may provide a more accurate result. However, both parties also agreed that the difference between using average figures and year end figures was minimal. Further, both parties agreed that the formula would be significantly easier to compute using the end of year figures appearing on standard financial statements. For these reasons, and absent any evidence of manipulation of those numbers by the taxpayer or respondent, we find that the year end figures should be used to calculate the percentage set forth in Notice 92-7.

Appellant also argues that respondent's calculations improperly deduct the amount of its credit union transactions from savings capital to arrive at the amount of SMSC used to derive the allocation percentage. Appellant points out, and respondent does not disagree, that respondent's treatment of member transactions skews the allocation percentage so that the maximum amount of deductible income from its members, including other credit unions, is matched with the maximum amount of SMSC. Appellant also contends that it is inappropriate to match any funds from SMSC, the income from which would be deductible under subdivision (c), with income from credit union transactions which would otherwise be deductible under subdivision (a) or (d). In support of its position, appellant argues that the statutory definition of SMSC does not allow for such a reduction. We agree with appellant that the statutory definition of SMSC equals member savings capital less member loans, and does not allow for a further reduction of that figure by member transactions; respondent should not reduce SMSC in that fashion to implement the terms of its Notice 92-7.

We do not agree, however, with appellant's contention that it is inappropriate to match some portion of appellant's income from member transactions with SMSC. As indicated in Notice 92-7, absent the ability to trace the use of particular funds, money is a fungible commodity, and therefore, "the source of any particular investment might be made up of dollars from members, retained earnings, nonmember loans to the credit union or reserve funds." The uncertain source of investment funds necessitates the use of a formula; those same concerns preclude an arbitrary determination that no portion of the income deductible pursuant to subdivision (a) or (d) arose from a deductible source pursuant to subdivision (c).

Respondent's method of determining SMSC for use in the formula, as well as its determination of the income subject to allocation, reduces, and may even negate, the effect of section 24405, subdivision (c). We doubt the legislature intended to enact a meaningless statute. In fact, it is clear from the legislative history that the statute is intended to treat state-chartered credit unions in a

manner more consistent with their federally-chartered counterparts which are not subject to tax on any portion of their investment income. (Assem. Com. on Rev. and Tax., Analysis of Assem. Bill No. 1581 (1987-1988 Reg. Sess.) As such, it is clear that the legislature intended to expand the deductions allowed to state-chartered credit unions, and respondent's interpretation does little to implement that intent. However, it is also apparent from the uncodified language enacted with the statute that the legislature did not intend to "exempt" equity capital from taxation. (Stats. 1987, ch. 1465, uncodified § 2, p. 5547.)

In our view, appellant presents the best means to implement these policies in the "compromise" formula presented as part of its moving papers. Appellant's compromise formula essentially begins with the formula set forth in Notice 92-7 and assumes further that appellant's income from all sources derives from proportionate parts of SMSC (deductible capital) and equity capital (non-deductible capital). As such, appellant's compromise position applies the ratio of SMSC to the sum total of SMSC and equity capital, to each component of investment income, including both income from taxable investments and from non-taxable investments with its members. Application of this formula effectively allocates a ratable share of all investment income between "taxable" and "nontaxable" sources. Thus the "compromise" formula provides a workable formula and a meaningful result consistent with the stated legislative purpose.

Appellant argues that this Board should abate interest⁹ which accrued prior to the issuance of Notice 92-7. Appellant argues that it is unfair to impose interest on assessed deficiencies when respondent failed to provide timely guidance as to its reporting guidelines. Respondent points out, and we agree, that the imposition of interest is mandatory, and interest is not subject to abatement upon a showing of reasonable cause. (Appeal of Amy M. Yamachi, Cal. St. Bd. of Equal., June 28, 1977.) Further, under facts similar to this appeal, this Board has held that it will not disturb respondent's decision not to abate interest. (Appeal of Nicholas Schillace, 95-SBE-005, Aug. 2, 1995; Appeal of Philip C. and Ellen Boesner Snell, 92-SBE-023, July 30, 1992.)

In summary, respondent is directed to apply the formula set forth in its Notice 92-7, as clarified by this opinion. In so doing, respondent should: adhere to the definition of equity capital set forth at Financial Code section 14400, subdivision (b); use the year end figures for both equity capital and SMSC in computing the proper allocation percentage; not deduct the amount of member transactions from SMSC in computing the allocation percentage; and, absent sufficient evidence of

⁹Because we do not know the precise impact of our determination on appellant's tax obligation, it is not clear that interest remains at issue in the instant case. However, the determination of appellant's appeal in that regard shall be set forth nonetheless.

tracing, apply the resulting allocation percentage to all of appellant's income to determine the ratable share of that income allocable to SMSC or equity capital. Finally, appellant's request for abatement of interest is denied.

Based on the legal and factual conclusions set forth above, respondent's determination is reversed to the extent it is inconsistent with results of this opinion, but sustained in all other regards.

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 19333 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of the San Francisco Police Credit Union against proposed assessments of additional franchise tax in the amounts of \$57, \$19,466, and \$63,548 for the income years ended December 31, 1988, December 31, 1989, and December 31, 1990, respectively, be and the same is hereby modified in accordance with the findings set forth above. .

Done at Sacramento, California, this 7th day of January, 1999, by the State Board of Equalization, with Board Members Mr. Klehs, Mr. Andal, Mr. Chiang, Mr. Parrish and Ms. Mandel* present, Mr. Andal not participating.

Johan Klehs _____, Chairman

_____, Member

John Chiang _____, Member

Claude Parrish _____, Member

Marcy Jo Mandel* _____, Member

*For Kathleen Connell per Government Code section 7.9.

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