

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In' the Matter of the Appeal of }
PASADENA FIRST NATIONAL BANK;
UNITED STATES HOLDING COMPANY }
AND UNITED STATES NATIONAL }
BANK OF SAN DIEGO, TRANSFEREES. }

For Appellants; C. Hugh Friedman,
Attorney at Law

For Respondent: Burl D. Lack, Chief Counsel;
Wilbur F. Lavelle, Associate
Tax Counsel.

O P I N I O N

This appeal is made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of Pasadena First National Bank, and United States Holding Company and United States National Bank of San Diego, Transferees, against a proposed assessment of additional franchise tax in the amount of \$6,815.56 for the income year 1955.

Pasadena First National Bank (hereafter, "appellant"), a national bank organized under federal law, had its principal office in Pasadena, California.. It employed the reserve method of accounting for its bad debts. On December 7, 1956, all of appellant 's assets, including loans receivable, were sold to another bank. Appellant ceased business on the date of the sale and on March 28, 1957, formally dissolved.

As part of the measure of appellant's tax for 1956, respondent included in appellant's income for 1955 the balance of its bad debt reserve as of the date of the sale and cessation of business. Appellant's protest was denied and this appeal followed.

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Section 23181 of the Revenue and Taxation Code provides for an annual tax upon every bank located in the state according to or measured by its *net* income, on the basis of its net income for the next preceding income year. Among the deductions permitted in computing net income is that provided by section 24348 of the Revenue and Taxation Code, which states in part: "There shall be allowed as a deduction debts which become worthless within the income year; or, in the discretion of the Franchise Tax Board, a reasonable addition to a reserve for bad debts."

Regulation 24348(b), title 18, California Administrative Code, adopted by respondent as a complement to section 24348 of the Revenue and Taxation Code, deals with the taxability of bad debt reserves of taxpayers who cease to be subject to the California franchise tax. It is there provided that:

Since addition to a bad debt reserve reduced the amount of tax which otherwise would have been due, any amount received from the sale or other disposition of receivables for more than their net tax basis in the year that a taxpayer ceases to be subject to the tax imposed by this part or ceases to be subject to a tax measured by net income is required to be included in the measure of tax for the last year that a taxpayer was subject to tax measured by or imposed upon net income to the extent that the amounts derived from such sale resulted in a tax benefit. As used in this regulation the term "net tax basis" means the face value of accounts receivable when sold, less amounts which have been set aside as a reserve for bad debts.

Applying this regulation, respondent determined that appellant's last taxable year was 1956, the year in which appellant transferred its loans receivable and ceased doing business. Since the tax due for 1956 is measured by the *net* income of the next preceding income year; i.e., 1955, respondent contends that the balance in the bad debt reserve account should be included in appellant's income for 1955.

It is undisputed that the regulation, if given effect, would require the inclusion of an amount equivalent to the bad

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debt reserve in the measure of appellant's tax for its last taxable year. Appellant's initial argument is that the regulation may not be given effect, and that under a rule established by the federal courts, the reserve is includible in income of the year 1956. The argument is made without discussion of the fact that under California law, the income of the last taxable year is not includible in the measure of the tax for that year',

By its election to use the reserve method, appellant subjected itself to the discretion of respondent. (Union Nat. Bank & Trust Co., 26 T.C. 537.) The scope 'of this discretion ~~is not limited to~~ the allowance or disallowance of an addition to the reserve, as argued by appellant. Respondent may, for example, require its consent as a prerequisite to changing from the reserve to the specific charge-off method (Rogan v. Commercial Discount Co., 149 F.2d 585, cert. denied, 326 U.S. 764 [90 L. Ed. 460]), and as a condition of its consent, respondent may require that the balance of the reserve be restored to income. (I.T. 2348, VI-I Cum. Bull. 67; S. Rossin & Sons, Inc. v. Commissioner, 113 F.2d 652.)

There is, under federal case law, a longstanding rule that additions to a reserve for bad debts previously deducted in computing taxable income must be included in taxable income when the reserve is no longer necessary. (Arcadia Sav. & Loan Assn., 34 T.C. 679, aff'd, 300 F.2d 247; Citizens Federal Sav. & Loan Assn. of Cleveland v. United States, 290 F.2d 932.) The theory underlying the restoration of reserve balances to income is that by taking deductions in earlier years the taxpayer benefited through a reduction of its taxable income, and subsequent events demonstrate that there was in fact no loss. (G. M. Standifer Construction Corp., 30 B.T.A. 184, 187.) The amount subjected to tax when the need for the reserve ceases, represents income earned in the past which has escaped taxation. (Ira Handelman, 36 T.C. 560, 568; West Seattle Nat. Bank of Seattle v. Commissioner; 288 F.2d 47.)

Under section 26422 of the Revenue and Taxation Code respondent has the power to issue all such rules and regulations as are necessary and reasonable to carry-out the provisions of the Bank and Corporation Tax Law. We do not believe that respondent has abused its discretion by enacting a regulation which circumscribes 'the operation of the bad debt reserve deduction within underlying principles well established in connection with similar federal legislation. In view of the prepayment characteristic of the California franchise tax; respondent's regulation is a necessary and reasonable provision which insures taxation of additions to a bad. debt reserve which have. resulted in tax benefit.

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In the alternative, appellant contends that even under the regulation the *assessment* was *not* made for the proper year. Reasoning that it was still "located" in this state and subject to tax until its formal dissolution, appellant concludes that according to the regulation the balance of the reserve should have been placed in *the measure of tax* for 1957, which would place it in the income year 1956 rather than 1955. Although it ceased business in 1956, appellant's position is that doing business is not a requirement for taxation of banks.

It is true that section 23181 of the Revenue and Taxation Code does not expressly require that a bank be doing business *in order* to be subject to tax. The language of the section is accounted for by the federal statute authorizing the taxation of national banks. (12 U.S.C.A. §548.) The federal statute permits a state to tax the shares of national banks "located within its limits" by one of several methods, including a tax "according to or measured by their net income. Thus, although the franchise of a national bank is granted by the federal government, a state may include in the measure of the tax imposed by it the net income derived from the exercise of the franchise.

"The United States Supreme Court has held that Congress intended by the federal statute to authorize a franchise tax (Traders Nat. Bank v. Oklahoma Tax Com., 309 U.S. 560; 563 [84 L. Ed. 947, 1934] and referring specifically to California's tax, the California Supreme Court has characterized it as a franchise tax "related to the privilege of engaging in the business of banking in the state." (Security-First Nat. Bank v. Franchise Tax Board, 55 Cal. 2d 407, 415, 417 [11 Cal. Rptr. 289, 359 P.2d 625]. See also, Traynor, National Bank Taxation in California (1929) 17 Cal. L. Rev. 232, 235.)

Appellant, therefore, ceased to be subject to the tax measured by income when it ceased business in 1956 and regulation 24348(b) operated to increase the measure of the tax for that year.

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,

I.

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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 protests of Pasadena First National Bank, and United States Holding Company and United States National Bank of San Diego, Transferees, to a proposed assessment of additional franchise tax in the amount of \$6,815.56 for the income year 1955, be and the same is hereby sustained.

Done at Sacramento, California, this 4th day of March, 1965, by the State Board of Equalization.

John W. Lynch, Chairman
Paul R. Lohr, Member
Robert Kelly, Member
Alan Cronin, Member
_____, Member

Attest: [Signature], Secretary