BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
FULLERTON SAVINGS AND LOAN)
ASSOCIATION)

For Appellant: Martin S. Schwartz
Attorney at Law

Robert J. Wynne
Attorney at Law

For Respondent: Crawford H. Thomas
Chief Counsel

Lawrence C. Counts
Counsel

Gary Paul Kane
Counsel

OPINION

This appeal is made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Fullerton Savings and Loan Association against proposed assessments of additional franchise tax in the amounts of $163.20, $6,842.81 and $8,893.68 for the income years 1959, 1961 and 1962, respectively, and pursuant to section 26077 of the Revenue and Taxation Code from the disallowance by the Franchise Tax Board of the claims of Fullerton Savings and Loan association for refund of franchise tax in the amounts of $6,188.22, $6,960.17, $1,463.26 and $5,385.75 for the income years 1959, 1960, 1961 and 1962, respectively. The refund claims were deemed disallowed pursuant to section 26076 of the Revenue and Taxation Code since the Franchise Tax Board did not act on them within six months after they were filed.

Appellant Fullerton Savings and Loan Association is a California corporation which was created in 1927. Pursuant to section 24348 of the Revenue and Taxation Code and the corresponding regulation, in 1959 appellant changed to the reserve method of cla iming bad debt deductions. Section 24348, subdivision (a), provides 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(a), title 18, California Administrative Code, states in part:

> (3) Rules Governing Use of Reserve Method. In determining the ratio of losses to outstanding loans for income years, beginning after December 31, 1958, a moving average is to be employed on a basis of 20 years experience, including the income year. This period of time was selected since it represents a sufficiently long period of an association's experience to constitute a reasonable cycle of good and bad. years. However, in lieu of the moving average experience factor an association may use an average experience factor based on any 20 consecutive years after the year 1927; provided, that for any 20-year period selected the association must use its own bad debt loss experience for the years that it was in existence during the period selected and the average bad debt loss experience of similar associations located in this State for such years as are necessary to complete the 20-year period. Associations which have not been in existence 20 years, see subparagraph (3)(ii). The percentage so obtained, whichever factor is used, applied to loans outstanding at the close of the income year, determines the amount of permissible reserve in the case of an association changing to the reserve method in such year ... and the minimum reserve which an association will be entitled to maintain in future years.... An association following a change to the reserve method of accounting or which continues such method for determining bad debts, may continue to take deductions from gross income equal. to. the current moving average or the alternative average percentage

> of actual bad debts times the outstanding loans at the close of the income year, or an amount sufficient to bring the reserve at the close of the year to the minimum, mentioned above, whichever is greater. Such continued deductions will be allowed only in such amounts as will bring the accumulated total at the close of any income year to a total not exceeding three times the moving average loss rate or the alternative method rate applied to outstanding loans....
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> (ii) ... If such association has not been in existence during all or part of either of the 20-year periods described at the beginning of this paragraph, it must use an average bad debt loss experience factor consisting of its own bad debt losses during the years for the period selected plus the average bad debt losses of similar associations located in this State for such years as are necessary to complete either of the 20-year' periods selected, The average bad debt losses of such associations for the years 1928 to 1947, inclusive, has been determined by the Franchise Tax Board to be 0.6 percent. The average bad debt loss for each year from 1928 to 1947, inclusive, is as follows..,. The statewide average loss allowance is applicable for all income years beginning after December 31, 1958.

The above statute and regulation represent a policy substantially identical to the federal policy in effect during the years in question.

In its returns for the income years 1959 and 1960 appellant claimed additions to its reserve account which were computed by use of a .15325 percent average bad debt loss experience factor.' This factor resulted from appellant's determination of its own bad debt loss experience over the period 1928 through 1947. For the income years.1961 and 1962 appellant initially claimed additions which were computed by use of the tentative .5 percent statewide average bad debt loss experience

factor for the above 20-year period. Subsequently appellant concluded that it should be allowed to compute the reserve additions for all of the above income years by use of the finally determined statewide factor of .6 percent. /Accordingly, appellant filed claims for refund.

Appellant contends that use of the statewide factor is justified because it is impossible to accurately determine the bad debt losses suffered by the association from 1928 through 1947. Appellant states that during the depression years its management took elaborate and often illegal measures to conceal bad debt losses or to postpone their occurrence. This was allegedly done to preserve appellant's public image, avoid bankruptcy, and to prevent a takeover by the California Building and Loan Commissioner. The management "doctored" or disposed of records, delayed foreclosures, personally purchased bad debts, and refinanced loans and then lent the borrowers additional funds so that they could pay the interest. Appellant states that as a result of these actions the available records for the above period indicate much smaller losses than those which the association did, in fact, experience.

After reaudit of appellant's returns, the Franchise Tax Board determined that appellant was not entitled to use the statewide factor but rather should have computed the additions by use of its own 1928 through 1947 average bad debt loss experience, which that board determined to be .15275 percent. Accordingly respondent issued deficiency assessments for the income years 1959, 1961 and 1962. Whether the Franchise Tax Board's determination was correct is the first issue of this case. Alternatively appellant takes the position that if this board holds that appellant must compute the additions by use of its own experience during the above 20-year period, then its proper average bad debt loss experience factor is .263041 percent, rather than .15275 percent as determined by respondent. Whether appellant's alternative position is correct raises the second issue of this case.

In respect to the first issue, we do not think that appellant was justified in using the statewide factor for the period extending from 1928 through 1947. Regulation 24348(a) explicitly states that an association must use its own bad debt loss experience for the years during the 20-year base period in which the association was in existence. In the case of Northern Bak, T.C. Memo., Dec. 3, 1962, the taxpayer argued that it should

be allowed to use substituted loss experience for the years 1928 through 1936 because the bank's prior management had failed to write off many bad debts which occurred during that period. The Tax Court stated that it believed that the federal rulings were reasonable and held that the bank must use its own experience. The use of substituted loss experience has also been denied in cases where bad debt losses during the depression years were kept very low by the prior management's conservative loan policy, which was subsequently liberalized. (First National Bank of La Feria, 24 T.C. 429, aff'd per curiam, 234 F.2d 868; Union National Bank & Trust Co. of Elgin, 26 T.C. 537.) And the use of such borrowed experience for the initial year(s) of a bank's existence, when losses were very low because borrowers' obligations had not yet matured, has been denied. (First National Bank in Olney, 44 T.C. 764, aff'd, 368 F.2d 164; First Commercial Bank, 45 T.C. 175.)

Appellant argues that the case of Union National Bank of Youungstown v. United States, 237 F. Supp. 753, and the Franchise Tax Board Legal Ruling 314, Aug. 25, 1966, control the instant situation. However the factual differences in the Union National Bank of Youngstown case clearly distinguish it from the present appeal. There the substituted experience was really the experience of old banks which in effect had become part of the new taxpayer bank. (First National Bank in Olney, supra; First Commercial Bank, supra.) The above legal ruling allows use of the statewide factor for years when an association was inactive or in the process of liquidation, but neither of these situations is present here.

Appellant also challenges the constitutionality of regulation 24348(a). This contention is based primarily on the equal protection clause of the Fourteenth Amendment to the United States Constitution which appellant argues is violated by the regulation's unreasonable and arbitrary discrimination between savings and loan associations on the basis of their dates of creation. Since this appeal includes claims for refund, we will consider constitutional questions. (Appeal of Richfield Oil Corp., Cal. St. Bd. of Equal., Mar. 2, 1950.) However, we are not convinced that unconstitutional discrimination exists here. The regulation's provision that associations may use their own loss experience during the depression years, and that associations which did not exist during that period may use the average statewide loss experience, seems to be a reasonable attempt to allow all associations the benefit of the high loss experience of the depression in the computation of the additions to their bad debt reserves. (See

Appeal of La Jolla Federal Savings and Loan Association, Cal. St. Bd. of Equal., Aug. 5, 1968.) In dealing with taxation, the utmost latitude under the equal protection clause must be afforded a state in defining categories of classification. (Allied Stores of Ohio, Inc, v. Bowers, 358 U.S. 552 [3 L. Ed. 2d 4805; Appeals of Pacific Coast Properties, Inc., et al., Cal. St. Bd. of Equal., Nov. 20, 1968.)

We must conclude that the Franchise Tax Board correctly determined that the additions to appellant's reserve should be computed by use of appellant's own available experience during the selected 20-year period, rather than by use of the statewide average experience.

The second issue of this appeal is concerned with appellant's contention that its own average bad debt loss experience during the period 1928 through 1947 was .263041 percent when computed by use of the date of foreclosure method, which appellant states is more favorable than the date of sale method used by respondent. Appellant has submitted a copy of its computations and the Franchise Tax Board has submitted a critical analysis of them. A taxpayer appealing from a Franchise Tax Board determination of reasonable additions to the bad debt reserve account has the heavy burden of proving that the board abused its discretion. (First National Bank in Olney, r a , 44 T.C. 764, aff'd, 368 F.2d 164; Appeal of The United Savings and Loan Association, Cal. St. Bd. of Equal., Nov. 19, 1968.) In the instant situation, after considering the information and arguments submitted by both parties, we do not think that appellant has carried this burden.

It is also relevant to note that the allowed additions to appellant's reserve for the income years in question, namely 1959, 1960, 1961 and 1962, were $22,614.40, $25,149.93, $29,775.71 and $32,848.67, respectively. During these years appellant did not suffer any bad debt losses. The reasonableness of additions to a reserve is measured in part by their adequacy in absorbing the losses actually incurred. (First Commercial Bank, supra, 45 T.C. 175; Appeal of Security First National Bank, Cal. St. Bd. of Equal., Nov. 19, 1968; Appeal of La Jolla Federal Savings and Loan Association, supra.) We conclude that the .15275 percentage determined by the Franchise Tax Board must be upheld.

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 Fullerton Savings and Loan Association against proposed assessments of additional franchise tax in the amounts of $163.20, $6,842.81 and $8,893.68 for the income years 1959, 1961 and 1962, respectively, and pursuant to section 26077 of the Revenue and Taxation Code, that the deemed disallowance by the Franchise Tax Board of the claims of Fullerton Savings and Loan Association for refund of franchise tax in the amounts of $6,188.22, $6,960.17, $1,463.26 and $5,385.75 for the income years 1959, 1960, 1961 and 1962, respectively, be and the same are hereby sustained.

Done at Sacramento, California, this 2nd day of June, 1969, by the State Board of Equalization.

John W. Lynch, Chairman

Paul R. Leake, Member

Richard Nevins, Member

_____, Member

_____, Member

ATTEST: _____, Secretary