BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

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

Appearances:

For Appellant: John J. Balian
Certified Public Accountant

For Respondent: 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 Lytton Savings and Loan Association against proposed assessments of additional franchise tax in the amounts of $9,362.32, $30,053.15, $60,609.83 and $98,382.89 for the income years 1959, 1960, 1961 and 1962, respectively.

The sole question presented is whether appellant was entitled to use the reserve method of accounting for bad debts without first requesting and obtaining respondent's permission.

Appellant, formerly named Home Builders Savings and Loan Association, has been in existence since 1908. Another corporation named Lytton Savings and Loan Association, hereafter referred to as "Old Lytton," was created in 1954. In 1959, Lytton Financial Corporation acquired the stock of Old Lytton and Home Builders. On June 13, 1960, Old Lytton was merged with Home Builders: Home Builders, the surviving corporation, thereafter changed its name to Lytton Savings and Loan Association, the appellant herein. Old Lytton had used the reserve method for deducting bad debts. and its existing reserve was carried over to appellant at the time of the merger.

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Appellant's franchise tax returns reflected that for the income years 1944 through 1959, no deductions were claimed for bad debts by either the reserve or specific charge-off method. Appellant's return for the income year 1943, however, disclosed the following information concerning a claimed deduction:

Brett Loan No. 8987 Balance reduced by action Board Directors to avoid probable greater loss if foreclosed	$10,346.35

The minutes of appellant's board of directors for their meeting of May 24, 1943, indicate that appellant decided to accept Mr. E. H. Brett's offer to pay principal of $56,068.50, plus applicable interest, as payment in full of a loan made to him, although the principal of the loan actually exceeded that amount by $10,346.35. It was further indicated in the minutes that $2,500 of the $10,346.35 "discount" would ultimately be recovered because the borrower and his wife would also agree to sign an unsecured five-year promissory note.

The minutes referred to the past difficulties in financing the property securing the Brett loan, the past concessions and adjustments already made, the recent independent appraisal of the property, and the limited rental income being received by Mr. Brett from the property in spite of his efficient management. The minutes also indicated the many efforts by Mr. Brett, at appellant's request, to seek refinancing elsewhere, his receipt of tentative proposals for new loans of but $40,000 to $50,000, and his final securing of a definite commitment enabling him to pay the $56,068.50 to appellant. Reference was also made to a written statement from Mr. Brett indicating present difficulties with ceiling rentals, increased operating expenses and other factors causing a lower net income to be produced notwithstanding full occupancy. According to the minutes, all board members concluded that the possibility of being forced to eventually take over the property could well involve a much greater loss than the "discount" approved. According to appellant, Mr. Brett owned and operated a business and was solvent in 1943. The accounting ledger card of the Brett transaction, however, indicates certain defaults in payments. In due course) the $56,068.50 payment was made and the $2,500 note was also paid in full..

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Appellant's state returns for the income years 1960 through 1962 were filed using the bad debt reserve method. No permission was requested to change to the reserve method until November 24, 1964. Included in that request was a statement that the filing of the application was not an admission that appellant; was not at that time and had not always been entitled to determine the amount of its bad debt deduction under the reserve method.

Respondent determined that the 1943 deduction of the Brett transaction was a specific charge-off of that portion of a debt which had become worthless. It then concluded appellant was not entitled to use the reserve method for the years under consideration on the ground it had not timely requested permission to change from a specific charge-off method to a reserve method of accounting for bad debts. With respect to the income year 1959, respondent added to Old Lytton's income the bad debt reserve which had been carried over to appellant and issued a notice of proposed assessment. That action was based on respondent's determination that the need for the reserve ceased with the transfer of Old Lytton's assets to appellant, since appellant had been deemed not to have been on the reserve method at the time of the transfer. The proposed tax liability for the four years is based partially on respondent's disallowance of appellant's use of the reserve method. Certain of the additional taxes reflected in the proposed assessments were based on adjustments not protested.

Appellant maintains that the 1943 deduction was not a bad debt but was either an ordinary and necessary business expense (Rev. & Tax. Code, § 24343) or a loss deductible under the general statutory provision relating to losses (Rev. & Tax. Code, § 24347).

In 1943 and for the years under consideration there was allowed as a deduction debts which became worthless within the income year; or, in the discretion of respondent, a reasonable addition to a reserve for bad debts. When satisfied that a debt was recoverable in part only, the respondent could allow such debt as a deduction in an amount not in excess of the part charged off within the income year. (Corporation Income Tax Act, § 7, subd. (e); Rev. & Tax. Code, § 24348, subd. (a).)

In 1959 respondent adopted a regulation applicable specifically to savings and loan associations. (Cal. Admin. Code, tit. 18, reg. 24348.) The regulation allowed an association to use either a reserve or specific

charge-off method of treating bad debts. It provided in part that:

> (a)(1)... The method originally adopted must be used for subsequent years unless the Franchise Tax Board consents to a change of accounting method in accordance with Section 24651. An association filing a first return of income may select either of the two methods, subject to approval by the Franchise Tax Board upon examination of the return. Application for permission to change the method of treating bad debts must be filed within 30 days prior to the close of the income year for which the change is to be effective.
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> (a)(7)... This regulation is applicable for all income years beginning after December 31, 1958. All associations now using the reserve method for determining their bad-debt reserve may continue such method, subject to the limitations of this" regulation. Any association desiring to adopt such method must obtain permission to change its accounting method as provided in paragraph (1).

The deduction taken by appellant in 1943 appears to be a specific deduction of that portion of a debt which had become worthless. The minutes and ledger card indicate that Mr. Brett was in default on certain past payments on his loan. The record indicates that there had been past concessions and adjustments. All board members agreed that being forced to take over the property could involve a much greater loss. Mr. Brett was unable to secure adequate financing from third persons to pay off the loan, Appellant apparently felt the entire amount could not be paid, or it conceivably could have further extended and liberalized the payment terms and interest rate. It is alleged that Mr. Brett was financially solvent and could have paid off the loan. If this were so we seriously doubt whether appellant, a corporation in the lending business, would have been willing to incur such a substantial loss.

Nor do we believe a deduction of a different nature would be allowable. The enactment of the specific statutory provision concerning bad debts indicates that such losses are to be considered as a special class and not deductible under other statutory provisions. (Spring City Foundry Co. v. Commissioner, 292 U.S. 182 [78 L. Ed. 1200); Dominick J. Salomone, 27 T.C. 663; Henry v. United States, 180 F. Supp. 597; Nicholas D'Alonzo, T.C. Memo., August 31, 1951.)

Appellant cites West Coast Securities Co., 14 T.C. 947, and Lab Estates, Inc., 13 T.C. 811, as authority for the proposition that the circumstances present in the reduction of the Brett debt gave rise to the applicability of other statutory deduction provisions, such as sections 24343 and 24347 of the Revenue and Taxation Code. In the West Coast Securities case the taxpayer was allowed to deduct as a business loss that portion of certain obligations which it had compromised. However in that case the obligations in question had not matured, nor were they in any way in default at the time, of settlement, and the compromise, therefore, did not stem from any determination of probable worthlessness but arose as a necessary incident of. the taxpayer's liquidation. In Lab Estates, Inc., supra, rent arrearages were adjusted by the taxpayer-lessor in exchange for the tenants* promises to continue their occupancy of stores in his hotel building. The tenants had been negotiating with third persons for other space at a lower rental. The tenants enhanced the business reputation of the taxpayer's hotel building by presenting a good appearance and fine window displays and attracting a wealthy clientele, The court allowed deduction of the rental adjustments either as business expenses or as losses.

In both West Coast Securities Co., supra, and Lab Estates, Inc., supra, compelling business reasons unrelated to any bad debt claim occasioned a settlement. Appellant maintains that there likewise were compelling business reasons for "discounting" and "compromising" the Brett loan. The evidence in this appeal indicates, however, that appellant was attempting to maximize its' return from an outstanding obligation and that the "discount" or "compromise" was nothing more than the recognition of a bad debt.

The Legislature by its enactment of the bad debt statutory provision made the deduction of a reasonable addition to a reserve for bad debts a matter within the discretion of the Franchise Tax Board.

Accordingly, unless the disallowance by respondent of the deduction claimed by appellant was arbitrary and capricious, constituting a clear abuse of discretion, its action must be sustained. Since appellant did not obtain permission before changing over from the specific charge-off method to the reserve method in 1960, as required by the regulations, it is clear that there was no abuse of discretion.

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 Lytton Savings and Loan Association against proposed assessments of additional franchise tax in the amounts of $9,362.32, $30,053.15, $60,609.83 and $98,382.89 for the income years 1959, 1960, 1961 and 1962, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 7th day of August, 1969, by the State Board of Equalization.

John W. Lynch, Chairman

_____, Member

_____, Member

_____, Member

_____, Member

ATTEST: _____, Secretary