

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
FIRST FEDERAL SAVINGS & LOAN)
ASSOCIATION OF SAN DIEGO)

Appearances:

For Appellant: Josiah L. Neeper,
Attorney at Law
For Respondent: Crawford H. Thomas,
Associate Tax Counsel

O P I N I O N

This appeal is made pursuant to section 26077 of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claims of First Federal Savings & Loan Association of San Diego for refund of franchise tax in the amounts of \$13,552.08, \$11,943.08, \$15,916.86 and \$12,791.71 for the income years 1954, 1955, 1956 and 1957, respectively.

Appellant makes loans on the security of real property. In addition to interest, it charges the borrower a loan fee in connection with the making of the loan. At the time the loan is made, the amount of the fee is either deducted from the proceeds paid to the borrower or is added to the amount of the borrower's note. Since the time appellant was organized in 1934, and until 1959, it recorded loan fees on its books as income in the year in which the loan was made, reflecting fees in excess of \$200,000 during each of the years in question.. It used the same accounting method for its franchise tax returns. As to all other items of income and expense it has used the cash receipts and disbursements method for its records and its franchise tax returns.

Appeal of First Federal Savings & Loan Association of San Diego

In 1959 appellant changed its method of accounting for loan fees and filed claims for refund for all prior years not then barred by the statute of limitations. Appellant's new method of accounting for loan fees is to take such fees into income **over** the life of the average loan. Appellant has never asked respondent for consent to file tax returns under its revised method **of** accounting.

Respondent denied the claims for refund and appellant filed this appeal. Appellant contends that its previous method of accounting was incorrect for a taxpayer using the cash receipts and disbursements method of accounting and that it has now changed to a correct method. It further contends that the prior **consent** of the Franchise Tax Board is not required when a taxpayer changes from an incorrect accounting method to a correct **one**.

Respondent states that appellant's old method was a hybrid method combining elements of both cash and accrual accounting and that while hybrid accounting methods were not recognized by statute until 1955, respondent has accepted the use by many savings and loan associations of methods the same as appellant's old method both before and, after 1955. In respondent's opinion, the method clearly reflects the income of an association which consistently follows it. **It** is contended that appellant was not authorized to change its method without **respondent's** prior consent,,

Since the applicable California legislation is based upon the federal income tax law, it is appropriate to consider the federal law and the cases interpreting it.

Before the passage of section 446 of the Internal Revenue Code of 1954, which expressly recognized the propriety of hybrid accounting methods, such methods were not generally permitted. (Estate-of Byrne; 16 T.C. 1234; Elsie SoRelle, 22 T.C. 459, See, however, Schram v. United States, 118 F.2d 541, where the commissioner was sustained in refusing to allow a change from a consistently used hybrid system.)

With respect to those years which preceded the adoption of section 446, the United States Tax Court held; over a vigorous dissent, that a change from a hybrid accounting method was merely the correction of an error and did not require the consent of the Commissioner of Internal Revenue. (American Can Co., 37 T.C. 198.)

Appeal of First Federal Savings & Loan Association of San Diego

Recently, however, the decision of the Tax Court in American Can was reversed on appeal, (American Can Co. v. Commissioner, 2 Cir., 317 F.2d 604,) The reversal was founded upon decisions by two other Circuit Courts of Appeal in Commissioner v. O. Liquidating Corp., 3 Cir., 292 F.2d 225, cert. denied, 368 U.S. 898 [7 L. Ed. 2d 94] and Wright Contracting Co. v. Commissioner, 5 Cir., 316 F.2d 249, The view thus adopted is that consent must be obtained from the commissioner to change a method consistently used in accounting for a material item even if the method is incorrect under the system employed by the taxpayer to account for most of his income or, in other words, even if the established approach amounts to a hybrid combination of cash and accrual methods.

The Tax Court has not as yet indicated its reaction to the reversal in the American Can case, that is, whether it will accept in other cases covering years prior to 1954 the rule followed by the above Circuit Courts. We believe, however, that the rule is sound, It is, in fact, in accord with earlier opinions by the Tax Court which emphasized that consistency is of key importance in an accounting system and that whenever a change is made distortions of income may result, making it essential that the commissioner be allowed to consider any contemplated change in advance,, (Advertisers Exchange, Inc., 25 T.C. 1086, aff'd, 240 F.2d 958; Geometric Stamping Co., 26 T.C. 301, Wright Contracting Co., 36 T.C. 620, aff'd, 316 F.2d 249.) With respect to those years following the adoption of section 446, it is clear that the Tax Court will not dispense with the requirement of the commissioner's consent simply because a change is made from a hybrid accounting system to a pure cash or accrual method, (Dorr-Oliver, Inc., 40 T.C. 50.)

Prior to 1955, the California law was essentially the same as the Internal Revenue Code of 1939 in the area under discussion. The California equivalent of section 446 of the Internal Revenue Code of 1954 was adopted in 1955. (Rev. & Tax. Code, § 24651,) Like section 446, the California statute expressly contemplates the use of hybrid accounting systems and, codifying a prior regulation (Cal, Admin. Code, tit. 18, reg. 25201b(1)), expressly requires the consent of the administering agency to any change in accounting method.

Appellant has not established that its former method of accounting, used for many years by appellant and by other corporations in the same field, failed to clearly reflect income, The practice of accruing a loan fee when the loan is

Appeal of First Federal Savings & Loan Association of San Diego

made, as appellant formerly did, has received judicial approval (Columbia State Savings Bank v. Commissioner, 41 F.2d 923) and it cannot be said that appellant's system as a whole did not clearly reflect income simply because it was hybrid in nature. (Rev. & Tax. Code, § 24651; Schram v. United States, 118 F.2d 541.)

In our opinion, guided by judicial interpretations of the **Internal** Revenue Code both before and after the adoption of section 446 of the 1954 code, appellant's attempt to change its method without the prior consent of the Franchise Tax Board was ineffective for tax purposes for any of the income years involved.

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 26077 of the Revenue and Taxation Code, ~~that~~ the action of the Franchise Tax Board in denying the **claims** of First Federal Savings & Loan Association of San Diego for refund of franchise tax in the amounts of \$13,552.08, \$11,943.08 \$15,916.86 and \$12,791.71 for the income years 1954, 1955, 1956 and 1957, respectively, be and the same is hereby **sustained**.

Done at Sacramento, California, this 18th day of February, 1964, by the State Board of Equalization.

Paul R. Lake, Chairman
John W. Lund, Member
Robert H. [unclear], Member
Robert [unclear], Member
[unclear], Member

ATTEST: [Signature], Secretary