

RESERVE FOR BAD &  
OF ACCOUNTANCY MET  
SAVINGS & LOAN COS.



BEFORE THE STATE BOARD OF EQUALIZATION  
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of )  
CULVER FEDERAL SAVINGS AND LOAN ASSOCIATION )

Appearances:

For Appellant: Joseph Mayer . . .  
Certified Public Accountant

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 Culver Federal Savings and Loan Association** for refund of franchise tax in the amounts of \$2,978.00, \$4,112.00 and \$4,965.00 for the income years 1959, 1960 and 1961, respectively,

Appellant, a savings and Loan association, commenced business in 1954. It maintained a reserve for bad debts **and took** deductions for additions to the reserve for federal income tax purposes. It incurred no actual bad debts and took no bad-debt deductions for state franchise **tax** purposes until 1961, **when it** claimed on its franchise tax return for the income year 1960 a deduction for an addition to a bad debt reserve in the amount of 0.2 percent of its savings accounts. A similar deduction, was claimed on its franchise tax return for the income year 1961, which was filed on March 15, 1962,

On March 13, 1962, respondent Franchise Tax Board disallowed the deduction claimed for the income year 1960 on

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the ground that appellant had not requested or been granted permission to change from a specific charge-off method to a reserve method of accounting for bad debts. On April 2, 1962, appellant filed an amended return eliminating the deduction for the income year 1961.

In a letter to respondent dated November 14, 1962, appellant made the following request:

Pursuant to Regulation 24348(a) pertaining to bad debt deduction for Federal Savings and Loan Associations, application is hereby made for permission to change to the reserve method of treating bad debts write-off .

Culver Federal Savings and Loan Association, organized June 30, 1954, adopted the specific charge off method and has employed this method through December 31, 1961.

Since Section 24651 provides that; application for change must be made thirty (30) days prior to close of the income year, your concurrence with this request effective January 1, 1962 is respectfully requested.

Appellant's request was granted on November 27, 1962.

On August 30, 1963, appellant filed claims for refund with respondent for the income years 1959, 1960 and 1961, on the ground that it was entitled to deduct an addition to its bad debt reserve for each of those years in the amount of 0.5 percent of its loans receivable. The claims were denied and this appeal followed.

Respondent's position is that since appellant did not claim any deductions on the reserve method for the first several years of its existence it had adopted the specific charge-off method, under which debts are deducted as they actually become worthless. In order to change methods, respondent argues, permission must be granted, and the permission granted in 1962 did not have retroactive effect.

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Appellant argues that it made no election to use the specific charge-off method; that it elected to use the reserve method in 1962; and that its election was effective for all years then open under the statute of limitations.

Section 24121f of the Revenue and Taxation Code, effective during the year 1954, and section 24348, its successor, permitted the deduction of "debts which become worthless during the income year; or, in the discretion of the Franchise Tax Board, a reasonable addition to a reserve for bad debts."

In 1952, respondent adopted regulation 24121f(1), title 18, California Administrative Code. This regulation provided that bad debts could either be deducted when they became worthless or a deduction could be taken as an addition to a reserve, and that:

A taxpayer filing a first return of income may select either of the above two methods subject to approval by the Franchise Tax Board upon examination of the return. If the method selected is approved, it must be followed in returns for subsequent years, except as permission may be granted by the Franchise Tax Board to change to another method. Application for permission to change the method of treating bad debts shall be made at least 30 days prior to the close of the income year for which the change is to be effective.

Thereafter, in 1959, respondent adopted regulation 24348(a). This regulation applied specifically to savings and loan associations, detailing particular means of computing their reserves. The regulation allowed either a reserve or specific charge-off method. It provided in part that:

(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

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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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(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 federal authorities have interpreted statutory and regulatory provisions which are very similar to those here involved and upon which the California provisions are based. These authorities, as we construe them, have established that no election is made to use the specific charge-off method of accounting for bad debts so long as no actual bad debts are incurred or deducted and that a subsequent election to use the reserve method is not a change requiring permission. (W. H. Langley & Co., 23 B.T.A. 1297; M. Morgenthau-Seixas Co., 25 B.T.A. 1235; Streight Radio and Television, Inc., 33 T.C. 127, aff'd, 280 F.2d 883, cert. denied, 366 U.S. 965 [6 L. Ed. 2d 1256]; Rev. Rul. 211, 1953-2 Cum. Bull. 21.) Until actual bad debts occur there is no necessity for an election and if no deductions have previously been taken there is no likelihood of a double deduction or other undue advantage by adopting either the reserve or the specific charge-off method.

The federal cases relied on by respondent are not inconsistent with the above rule. In Albert C. Becken, Jr., 5 T.C. 498, the court merely held that the taxpayer had made an election to use the reserve method in the first return that he filed with respect to a newly established business. And in Charles Dennis Williams, T.C. Memo., Dkt. Nos. 90538, 90539,

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Nov. 15, 1962, the holding was that the taxpayer's procedure did not constitute an adoption of or election to use the reserve method at all. Those cases did not hold that a failure to claim any deduction would constitute an election to use the specific charge-off method. The case of Straight Radio and Television, Inc., supra, 33 T.C. 127, which is cited by respondent, appears to us to support the rule that we have found.

Our own previous decisions, also cited by respondent, are equally distinguishable. In Silver Gate Building and Loan Association, Cal. St. Bd. of Equal., Aug. 19, 1957, and Citizens Savings and Loan Association, Cal. St. Bd. of Equal., Nov. 14, 1960, the taxpayers did not maintain bad debt reserves on their books. They had, moreover, received specific instructions that savings and loan associations which had not obtained permission to use the reserve method were required to use the specific charge-off method. Those instructions represented the rule followed by respondent before it adopted the regulations which we have quoted in this opinion.

Appellant's letter of November 14, 1962, stating that appellant had adopted the specific charge-off method and requesting permission to change, was obviously a formality motivated by respondent's rejection of the attempt to deduct an addition to the reserve in the return for the income year 1960. The statement that appellant had adopted the specific charge-off method was not in accord with the actual facts and must be disregarded.

Although appellant apparently regards its election as having been made in 1962, it is manifest that the election to use the reserve method was made in the original return for the income year 1960. At no time has respondent indicated disapproval of the use of the reserve method by appellant due to factors related to appellant's operation. On the contrary, it has specifically approved appellant's use of this method for income years subsequent to those on appeal. Based on an erroneous conclusion that appellant's failure to select a method in its early returns constituted an election to use the specific charge-off method, respondent merely took the position that a change from that method to the reserve method required permission. Since there was no change, no permission was required. Appellant, therefore, properly elected to use the reserve method in its original return for 1960 and became committed to the use of that method for future years in the absence of permission to change to the specific charge-off method.

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There remains the question whether appellant may deduct an addition to its reserve for the income year 1959. Cases cited by respondent have held that once an addition to a reserve is made, the amount may not subsequently be increased for that year. (Farmville Oil and Fertilizer Co. v. Commissioner, 78 F.2d 83; Rogan v. Commercial Discount Co., 149 F.2d 585, cert. denied, 326 U.S. 764 [90 L. Ed. 460].) But if a taxpayer at the end of a given year determines and enters in its books an addition to its reserve for that year, it may in a later period claim a deduction in that amount for that year, (Rio Grande Building and Loan Association, 36 T. C. 657.) As we understand the facts, appellant entered in its books an addition to a reserve for the income year 1959, and deducted it for federal income tax purposes. That being so, we believe appellant may properly deduct for franchise tax purposes that amount or such lesser amount as respondent may, in the proper exercise of its discretion, determine to be reasonable.

Respondent has stated that, in the event appellant is permitted to use the reserve method for the years in question, it wishes to refer the matter to its auditors to compute the allowable deductions. Appellant has agreed to accept any such computations. Our conclusion, therefore, is that appellant may deduct for each of the years in question an addition to its reserve for bad debts in such reasonable amount as may be determined by respondent, but not exceeding the amount entered on appellant's books 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,

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 on the claims of Culver Federal Savings and Loan Association for refund of franchise tax

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in the amounts of \$2,978.00, \$4,112.00 and \$4,965.00 for the income years 1959, 1960 and 1961, respectively, be modified as follows: Appellant shall be allowed to deduct for each of the years involved an addition to its reserve for bad debts in such reasonable amount as may be determined by the Franchise Tax Board, but not in excess of the amount entered on appellant's books as an addition to its reserve for bad debts for that year, and the refunds due shall be recomputed accordingly.

Done at Pasadena, California, this 14th day of February, 1966, by the State Board of Equalization.

Paul R. Leake, Acting Chairman  
Richard C. ..., Member  
John W. Lynn, Jr., Member  
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ATTEST: W. F. ... Secretary