



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of **the**. Appeal of
THE UNITED SAVINGS AND LOAN ASSOCIATION }

For Appellant: Carl A. Stutsman, Jr.
Attorney at Law

For Respondent: Crawford H. Thomas
Chief Counsel

Gary Paul *Kane*
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 protest of The United Savings and Loan Association against a proposed assessment of additional franchise tax in the amount of \$2,464.31 for the income year 1961.

The United Savings and Loan Association, hereafter referred to as appellant, was formed in October of 1955, and commenced doing business on March 31, 1956. It was organized for the purpose of acquiring all the real estate loans, savings accounts, and the business offices of the Porterville Savings and Loan Association, hereafter referred to as **Porterville**. The latter association was organized in 1905 and evidently was actively doing business until approximately 1953 or 1954. Appellant states that at that time Porterville did not have a substantial amount of cash with which to make loans, it was not taking in new funds, and it was following a very conservative loan policy with respect to the two or three loans per month which it did make. Appellant states that this loan policy required a 50 percent down payment, restricted loans to 50 percent of market value and to within an area of ten or twelve miles of the City of Porterville. In contrast to this

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previous loan policy, appellant states that its new management set up a liberal policy which permitted loans to be made up to 75 to 80 percent of market value, and within a radius of 50 miles from the city.

Pursuant to regulation 24348(a), title 18, California Administrative Code, appellant chose to use the reserve method of accounting for its bad debts. Appellant computed the addition to its reserve for the year in question by using the 0.6 percent average bad debt loss experience of similar associations located in California during the period 1928 to 1947. Respondent disallowed the use of this average experience and determined that appellant should use the 0.197 percent experience of its predecessor, Porterville, which had been in existence during the selected 20-year period. Whether this determination was correct is the sole issue of this case.

Section 24348 of the Revenue and Taxation Code 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." A taxpayer appealing, from a Franchise Tax Board determination of a reasonable addition to a reserve has the heavy burden of proving that the board acted arbitrarily and capriciously, thereby abusing its discretion. (First National Bank In Olney, 44 T.C. 764, aff'd, 368 F.2d 164; Appeal of La Jolla Federal Savings and Loan Ass'n, Cal. St. Bd. of Equal., Aug. 5, 1968.)

The Franchise Tax Board's regulation 24348(a), *supra*, provides 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

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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)....

(i) In computing the moving average or **alternative method** percentage of actual bad debt losses to loans, the average should be computed on loans comparable in their nature and risk involved to those outstanding at the close of the current income year involved....

(ii) A newly organized association or an association which arises as the result of a merger, consolidation or the acquisition of substantially all of the assets of a predecessor association without sufficient **years'** experience for computing an average as provided for above will be permitted to set up a reserve commensurate with the average experience of other similar associations with respect to the same type of loans. 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.... In determining the average experience of similar associations the experience of associations which have ceased operations prior to the effective date of this regulation was disregarded. However, if such association was operated by a successor association as the result of a **merger**, consolidation or transfer of substantially all of the assets of its predecessor, the average experience of the acquired association with respect to the same type loans was combined with the average experience of the successor association....

The above statute and regulation represent a policy substantially **identical** to the federal policy in effect during the year at issue.

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In Appeals of Home Savings and Loan Association, et al., Cal. St. Bd. of Equal., July 6 1967, the taxpayer association had acquired substantially all of the assets and liabilities of eight other savings and loan associations. We stated that regulation 24348(a) implicitly assumes the propriety of using the loss experience of a predecessor, and we discussed the federal cases of Pullman Trust and Savings Bank v. United States, 235 F. Supp. 317, aff'd per curiam, 338 F.2d 666, and Union National Bank of Youngstown v. United States, 237 F. Supp. 753, both of which allowed the taxpayer's use, during the 20-year period, of the loss experience of its predecessor(s) for years prior to the taxpayer's existence and upheld the taxpayer's use of the combined loss experience of the taxpayer and its predecessor(s) for year(s) when they coexisted. Our conclusion was that a meaningful loss experience, in the case of an association which is an amalgamation of previously existing associations, may be achieved by combining the loss experience of all, and therefore the Franchise Tax Board's determination was upheld. We think that Appeals of Home Savings and Loan Association, et al., supra, and the federal cases it relied upon control the present situation.

Appellant points out that the loan policy of its predecessor during the last several years of its existence was more conservative than the policy which appellant adopted. Therefore it implies that Porterville's experience was not computed on loans comparable in their nature and risk to loans which appellant had outstanding at the end of the year in question. However, appellant has not shown that the loan policy which Porterville followed during its last several years was the same policy which it followed during the selected period, 1928 to 1947. Nor has appellant proven that its loss experience has been or is reasonably expected to be higher, as a result of its liberalized loan policy, than the experience of its predecessor. Consequently this change of policy can not serve as the basis for appellant's use of the statewide loss experience. (First National Bank of La Feria, 24 T.C. 429, aff'd per curiam, 234 F.2d 868; Union National Bank and Trust Co. of Elgin, 26 T.C. 537; American State Bank v. United States, 176 F. Supp. 64, aff'd 279 F.2d 585, cert. denied, 364 U.S. 881 [5 L. Ed. 2d 1031.])

We must conclude that respondent did not abuse its discretion by using the bad debt loss experience of appellant's predecessor during the selected 20-year period in order to compute the addition to appellant's reserve for the year in question.

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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 The United Savings and Loan Association against a proposed assessment of additional franchise tax in the amount of \$2,464.31 for the income year 1961, be and the same is hereby sustained.

Done at Sacramento, California, this 19th day of November, 1968, by the State Board of Equalization.

Paul A. Klein, Chairman
John W. Lynch, Member
[Signature], Member
[Signature], Member
[Signature], Member

ATTEST:

[Signature], Secretary