

Appeal of State Mutual Savings
and Loan Association

<u>Income Year</u>	<u>Proposed Assessment</u>
1962	\$35,299.88
1964	77,125.37
1965	7,103.06
1966	15,848.47
1968	32,784.15
1969	6,981.31

Subsequent to the filing of this appeal, appellant filed a separate appeal, pursuant to section 26077 of the Revenue and Taxation Code, from the action of the Franchise Tax Board in denying its claims for refund of franchise tax in the amounts and for the years as follows:

<u>Income Year</u>	<u>Proposed Assessment</u>
1962	\$103,566.00
1963	204.00
1964	178,935.00
1965	48,074.00
1966	41,351.00
1967	67,144.00
1968	15,586.00
1969	121,962.00
1970	3,965.00
1971	25,154.00

Thereafter, appellant paid in full the proposed assessments which gave rise to its initial appeal. Accordingly, pursuant to section 26078 of the Revenue and Taxation Code, the initial appeal is also treated as an appeal from the denial of claims for refund.

In accordance with the request of appellant, acquiesced in by respondent, the two appeals have been consolidated for purposes of this opinion. The primary issue presented by the appeals is whether respondent abused its discretion in refusing to allow the total amount of deductions claimed by appellant for additions to its bad debt reserve. Collateral issues presented by the appeals will be discussed in connection with the particular facts to which they relate.

Appellant is a state savings and loan association. It was incorporated under the laws of California in 1889, and it is authorized to make loans in California, Oregon, Nevada, and Arizona.

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During the years on appeal, a savings and loan association could elect to compute its bad debt reserve additions on the basis of either a current 20-year moving average loan loss experience factor or an average loan loss experience factor derived from any 20 consecutive years after the year 1927. However, for any 20-year period selected, the association was required to use its own loan loss experience for the years that it was in existence during such period and the average loan loss experience of similar associations located in the state for such years as were necessary to complete the 20-year period. (Cal. Admin. Code, tit. 18, reg. 24348(a).) ^{1/} In computing its reserve additions under either method, the association was allowed to consider its foreclosure losses as part of its total loan loss experience during the selected 20-year period. In computing the amount of its foreclosure losses, the association could elect to use either the fair market value of each property on the date of foreclosure (date of foreclosure method) or the adjusted basis of each property as of the date of sale following foreclosure (date of sale method). ^{2/} (Cal. Admin. Code, tit. 18, reg. 24348(a), para. (5).) ^{2/}

For each of the years on appeal, appellant elected to compute its annual reserve addition on the basis of its average loan loss experience over the 20-year period from 1928 through 1947. During that period appellant acquired through foreclosure 1,863 properties located in California, Arizona, and Oregon. Appellant

^{1/} Regulation 24348(a) is applicable for income years beginning after December 31, 1958 and before January 1, 1972. (Cal. Admin. Code, tit. 18, reg. 24348(a), para. (7).) For purposes of computing reserve additions for those income years, the ratio obtained from the selected 20-year base period is applied to the association's outstanding loan balance at the close of the income year.

^{2/} Under the date of foreclosure method, the foreclosure loss is equal to the particular loan balance on the date of foreclosure less the fair market value of the foreclosed property on that date. Under the date of sale method, the loss is equal to the adjusted basis of the property on the date of sale less the sale price.

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elected to compute the amounts of the foreclosure losses using the date of sale method rather than the date of foreclosure method. As a result of its computations, appellant determined that its average loan loss ratio for the selected 20-year period was .4890 percent, and appellant applied that ratio to compute the reserve additions initially claimed on its returns.

After conducting an audit of appellant's returns, respondent determined that in computing the amounts of its foreclosure losses under the date of sale method appellant had failed to properly adjust the basis of each foreclosed property to reflect depreciation between the date of foreclosure and the date of ultimate sale. Respondent concluded that appellant's average loan loss ratio under the date of sale method was .3341 percent rather than .4890 percent as reported by appellant. Accordingly, respondent adjusted appellant's bad debt reserve additions to reflect application of the reduced loan loss ratio and issued the proposed deficiency assessments which gave rise to the initial appeal.

Appellant protested the deficiency assessments on the ground that the date of sale method for computing foreclosure losses does not, or should not, require an adjustment of the basis of each property to account for depreciation. However, the assessments apparently also **prompted appellant to consider** using the date of foreclosure method to compute its foreclosure losses. In this connection, appellant inquired whether respondent would accept retroactive appraisals of a ten percent "representative" sample of the properties acquired through foreclosure, in lieu of retroactive appraisals of all the properties, for purposes of establishing the respective values of the properties on the dates of foreclosure. Respondent advised appellant that retroactive appraisals of all the properties would be required if appellant elected to use the date of foreclosure method. Appellant then informed respondent that the retroactive appraisals of all the properties would be submitted in five percent increments.

In a letter accompanying the first group of appraisals, appellant's vice president stated: "We very earnestly wish to explore the possibility of resolving this matter by compromise without the necessity to appraise all properties." Respondent considered the data submitted by appellant and, in a letter dated February 6, 1973, offered to allow appellant to use a loan loss

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ratio of .3763 percent for purposes of computing its reserve additions. Appellant's response challenged the ratio proposed by respondent and suggested changes in the method used by respondent to compute the ratio. Subsequently, appellant offered to settle the case by using a loan loss ratio of .4281 percent to compute its reserve additions. In a letter to appellant dated October 16, 1973, respondent rejected the offer to settle and again advised appellant that retroactive appraisal of all properties would be required if appellant still desired to use dates of foreclosure to establish its foreclosure losses. Thereafter, appellant declined to submit any additional appraisal information.

The Legislature, by its enactment of section 24348, has made the reasonableness of additions to a bad debt reserve a matter within the discretion of respondent. Accordingly, unless appellant sustains the heavy burden of proving that respondent has abused its discretion through arbitrary and capricious action, respondent's adjustment to appellant's reserve additions must be upheld. (Appeal of La Jolla Federal Savings and Loan Association, Cal. St. Bd. of Equal., Aug. 5, 1968.)

Initially, appellant contends that respondent acted arbitrarily and capriciously in withdrawing its settlement offer. Apparently, it is appellant's position that the parties' settlement negotiations culminated in a formal agreement which must be given binding effect. We disagree.

The record on appeal indicates that the negotiations between appellant and respondent regarding possible settlement did not culminate in a final agreement as to a mutually acceptable loan loss ratio. To the contrary, the record indicates that respondent effectively withdrew its offer to settle prior to any communication of an unqualified acceptance by appellant. Furthermore, under both federal and California tax law, a prerequisite to binding compromise agreements is strict compliance with the statutes authorizing such agreements. (Botany Worsted Mills v. United States, 278 U.S. 282, 288 [73 L. Ed. 379] (1929); Appeal of Charles R. Penington, Cal. St. Bd. of Equal., Jan. 20, 1954.) In the instant case there is no evidence that the statutory procedure for proper execution of a binding settlement agreement was followed. (Rev. & Tax. Code, § 25781; see Appeal of International Wood Products Corp., Cal. St. Bd. of Equal., Feb. 19, 1974.)

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Appellant also contends that respondent's refusal to accept the "representative" sample of retroactive appraisals for purposes of establishing appellant's foreclosure losses constituted an abuse of discretion. Appellant's conclusion is based primarily on the "economic impossibility" of obtaining retroactive appraisals of all 1,863 properties. Appellant also suggests that respondent's settlement offer constituted an "implicit acceptance of the sample submitted."

Paragraph (5) of regulation 24348(a) clearly provides:

(i) In determining the amount of bad debt loss sustained on account of foreclosures where the collateral is taken over by the association, the fair market value of the collateral shall be established by competent appraisal. (Emphasis added.)

In applying this provision, respondent has consistently required all associations seeking to establish foreclosure losses as of the dates of foreclosure to obtain retroactive appraisals of all properties acquired through foreclosure during the selected base period.^{3/} Moreover, this board has previously considered and upheld respondent's policy of requiring such appraisals. (Appeal of California Federal Savings and Loan Association, Cal. St. Bd. of Equal., March 2, 1977; Appeal of People's Federal Savings and Loan Association, Cal. St. Bd. of Equal., Feb. 6, 1973.)

Appellant has failed to convince us that respondent's refusal to deviate from its established policy constituted an abuse of discretion. We reject as without substance appellant's argument that it should be excused from obtaining the required appraisals on the ground of

^{3/} A retroactive appraisal is not required where the property was sold within six months after foreclosure or where there was a valid appraisal by a federal regulatory agency within six months of foreclosure. In those situations it is respondent's policy to accept the sale price or government appraisal in lieu of retroactive appraisal. (See Appeal of People's Federal Savings and Loan Association, Cal. St. Bd. of Equal., Feb. 6, 1973.)

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"economic impossibility." (See Appeal of California Federal Savings and Loan Association, supra; Appeal of Fullerton Savings and Loan Association, Cal. St. Bd. of Equal., June 2, 1969.) We must also reject appellant's argument that respondent's settlement offer constituted an "implied acceptance" of the "representative" appraisals. Although respondent considered the data in computing the proposed compromise ratio, we do not view the settlement offer as a concession by respondent that it would be unreasonable to require appellant to obtain appraisals of all the properties in question. Furthermore, we do not believe it would be proper, as a matter of policy, for this board to consider an unaccepted settlement offer as evidence of an admission or a concession. (See Witkin, Cal. Evidence (2d ed. 1966) § 378, p. 336; Estate of Johanson, 62 Cal. App. 2d 41, 56 [144 P.2d 72] (1943).)

For the reasons stated above, we conclude that respondent's actions in connection with appellant's attempt to establish its foreclosure losses under the date of foreclosure method did not constitute an abuse of discretion. We turn now to a consideration of the propriety of respondent's action in reducing the loan loss factor initially--claimed by appellant. As we have indicated, respondent reduced the factor on the ground that appellant failed to account for depreciation in applying the date of sale method to compute its foreclosure losses.

Appellant contends, generally, that it is unnecessary and unreasonable to require the depreciation adjustment for purposes of obtaining an accurate indication of foreclosure losses under the date of sale method. However, in the Appeal of People's Federal Savings and Loan Association, supra, we stated:

When an association elects to determine its [foreclosure] losses at the time of ultimate disposition of the foreclosed property rather than at the time of foreclosure, a portion of the loss is attributable to the exhaustion, wear and tear of the improvement on the property between foreclosure and ultimate disposition. For this reason the regulations in effect during the years at issue required that where losses were determined upon ultimate disposition of the foreclosed property, the basis of the property be adjusted for depreciation. (Cal. Admin. Code, tit. 18, reg. 24348 (a), subd. (5); Rev. & Tax. Code, § 24916.)

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In accordance with our decision in the above appeal, and for the reasons stated therein, we conclude that respondent properly reduced appellant's loan loss factor to account for the depreciation between the dates of foreclosure and the dates of sale.

The remaining issues presented by these appeals involve various assertions made by appellant regarding the constitutionality of regulation 24348(a).

Appellant contends that the regulation operates to arbitrarily discriminate against savings and loan associations on the basis of their dates of creation. Specifically, for purposes of computing current reserve additions, the regulation allows associations which were not in existence during the 20-year period from 1928 through 1947 to use the average actual loan loss experience of associations that were in existence during such period. However, associations which were in existence during the period are required to use their own actual loan loss experience in computing an average loan loss ratio even though such ratio may be significantly lower, as in appellant's case, than the ratio obtained from the statewide average. (Cal. Admin. Code, tit. 18, reg. 24348(a), para. (3).) Thus, it is appellant's position that the regulation arbitrarily creates a class of associations which is deprived of the benefits accorded other associations **under the regulation and which is therefore** subject to discriminatory taxation.

In support of its position, appellant relies on a recent superior court decision in Glendale Federal Savings and Loan Association v. Franchise Tax Board (Super. Ct. Los Angeles Co., No. C-61539). Apparently, the decision consisted of a minute order granting the relief requested by the plaintiff without discussion of the rationale for the decision. The minute order has not been made part of the record for these appeals. However, respondent has submitted a summary of the arguments made by the plaintiff before the superior court. It appears the plaintiff asserted that regulation 24348 (a) discriminates against federal savings and loan associations originally chartered during the years 1933 through 1937 because it deprives such associations of the use of the relatively high bad debt losses sustained on pre-1932 loans by California savings and loan associations. (See generally Appeal of Glendale Federal Savings and Loan Association, Cal. St. Bd. of Equal., April 9, 1973.) Thus, the plaintiff concluded that it should be

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entitled, in computing its current reserve additions, to use the highest loan loss ratio permitted its most favored competitor under regulation 24348(a).

This board has previously considered and rejected a constitutional objection by a state chartered savings and loan association to regulation 24348(a) identical to that advanced by appellant in the instant appeals. (Appeal of Fullerton Savings and Loan Association, supra.) On the basis of our prior decision and for the reasons stated therein, we conclude appellant has failed to establish that it has been subjected to discriminatory taxation by the operation of regulation 24348(a).

With respect to the superior court decision relied on by appellant, we are not convinced that the result reached in that case should serve as the basis for resolution of the instant appeals. Initially, it is our opinion that the position of appellant in relation to regulation 24348(a) is significantly different from that of the plaintiff in the superior court action. Unlike the federal association originally chartered subsequent to the high loan loss years of the depression, appellant was in existence during those years and was able to look to its own experience for purposes of computing its current reserve additions. The mere fact that appellant's actual loan loss experience during the depression period reflects a more conservative lending policy than that of its competitors does not, in our opinion, support appellant's assertion that it should be accorded the same treatment as the federal association. Furthermore, since the superior court decision is in the form of a simple minute order, we have no way of knowing whether the court's decision is actually relevant to the constitutional question presented by the instant appeals. Thus, we must refuse to consider the decision as persuasive support for appellant's position.

Appellant has made a number of other arguments in support of both its initial appeal and its subsequent claims for refund.^{4/} We have considered the arguments and find them all to be without merit.

^{4/} A portion of the briefs submitted with these appeals address the question whether appellant's subsequent refund claims are barred by the applicable statute of limitations. However, in view of the conclusion reached with respect to the arguments made by appellant in support of the claims, we find it unnecessary to reach the statute of limitations question.

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In summary, we have been asked by appellant to find that respondent has abused its discretion in applying various provisions of regulation 24348(a) for purposes of computing appellant's proper reserve additions for the years on appeal, and we have been asked to find that the regulation itself is unconstitutional. Instead, we have found that respondent's actions have been consistent with the regulatory provisions in question, as well as with respondent's established policy and practice. We have also concluded that appellant's attacks on the constitutionality of regulation 24348(a) are without merit. Accordingly, respondent's actions in these matters must be sustained.

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,

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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 State Mutual Savings and Loan Association for refund of franchise tax in the amounts and for the years as follows:

<u>Income Year</u>	<u>Refund Claim</u>
1962	\$ 35,299.88
1962	103,566.00
1963	204.00
1.964	77,125.37
1964	178,935.00
1965	7,103.06
1965	48,074.00
1966	15,848.47
1966	41,351.00
1967	67,144.00
1968	32,784.15
1968	15,586.00
1969	6,981.31
1969	121,962.00
1970	3,965.00
1971	25,154.00

be and the same is hereby sustained.

Done at Sacramento, California, this 29th day
of June , 1978, by the State Board of Equalization.

George P. Kelly, Chairman
Paul C. Lee, Member
William B. Bennett, Member
James J. Sankey, Member
_____, Member