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0100 INTRODUCTION AND OVERVIEW OF THE BANKING AND FINANCIAL INDUSTRIES

The purpose of this handbook is to provide auditors with an overview of how the financial industry operates, identification of issues unique to the financial industry, techniques on how to develop the facts relative to the issues, and the department's position on the issues.
0104 BANKS (IN GENERAL)

What is a bank? Generally, a bank is an entity in which a substantial part of its business consists of receiving deposits and making loans. Deposits may be in the form of certificates of deposits, savings accounts, checking accounts, money market accounts, etc. Loans may be commercial, consumer, mortgages, government obligations, etc.

As a general rule, banks are incorporated under the laws of the United States, its political subdivisions (states, District of Columbia, or territories) or foreign countries.

IRC Section 581 provides the definition of a bank. Note that this definition is limited to the purposes of IRC Sections 582 and 585.

R&TC Sections 23037, 23038, and 23039 define "taxpayer," "corporation", and "bank".

R&TC Section 23039 defines "bank" as follows:

Bank includes national banking associations. Bank includes any bank operated by a receiver, liquidator, referee, trustee or other officers or agents appointed by any court, or assignee for the benefit of creditors. Clearly the above definition is not all-inclusive. For example, it does not define a state-chartered bank as a bank.

The term bank is further defined under the California Financial Code Sections 102, 103, 106, 107, and 109 as follows:

- **Section 102.** The word "bank" as used in this division means any banking institution that has been incorporated to engage in the commercial banking or trust business...

- **Section 103.** Banks are divided into the following classes:

  (a) Commercial banks
  (b) Trust companies

- **Section 106.** "Trust business" means the business of acting as executor, administrator, guardian, or conservator of estates, assignee, receiver, depository or trustee under appointment of the court, or by authority of any law of this or any other state of the United States, or as trustee for any purposes permitted by law.
• **Section 107.** "Trust company" means a corporation or a commercial bank that is authorized to engage in the trust business...

• **Section 109.** "Bank" or "banks" embrace commercial banks and trust companies unless the context otherwise requires.

It would appear that for purposes of the Revenue & Taxation Code, one of the following elements must be present to have a bank:

- The entity must be incorporated under the laws of the United States or its political subdivisions or under the laws of another country to both take deposits and make loans.
- The entity must operate as a Trust Company as defined in the Financial Code.

The issue of a trust company as a bank has been addressed in cases in protest. Issues include classification of a trust company as a bank for purposes of application of the bank rate, (R&TC Section 23181), the exclusion from other taxes (R&TC Section 23182), and the correct method of apportionment for the unitary group that includes the trust company.

The facts in each of these cases were similar. The trust companies were organized under the authority of the California State Banking Department and there was a copy of the State Banking Department’s letter approving the application of the trust company for trust business. This is the single most significant piece of evidence in the determination that a trust company is within the definition of a bank.

Some of the following factors were also present in each of the cases. Although the trust was a limited purpose bank (as defined by the State Banking Department) governed by the laws of the State of California, the trust’s management adopted the standards of Regulation 9. This Regulation is issued by the Office of the Comptroller of the Currency governing trust activities of national banks, as these standards generally reflect practices followed in the industry. The trust company’s business activities involved serving as trustee for employee benefit plans and providing custody services for investment portfolios. The trust company serviced employee benefit trusts, such as defined benefit and defined contribution pension plans, and had ultimate responsibility for the plan level administration of the institutional trust accounts including liaison with third party plan administrators and record keepers. The trust company may or may not have exercised investment management decision-making authority in these accounts. Account administration included client accounting and reporting, participant loan administration, and compliance with the Employee Retirement Income Security Act.

Classification as a Bank: In addition to the sections of the California Financial Code that include a trust company within the definition of a bank, the courts and the State Board of Equalization have determined that the definition of banks in California includes trust companies. (See **Appeal of Title Insurance and Trust Co., Cal. St. Bd. of Equalization, January 27, 1949; Title Insurance and Trust Co.**

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These trust companies did not meet the definition of a financial corporation in CCR Section 23183 because they failed the "deals in" test. The trust companies did not conduct transactions in the course of a trade or business on its own account. (See CCR Section 23183(b)(2).)

It was the conclusion as a part of the protest that these trust companies were within the definition of a bank under California Financial Code Sections 102, 103, 106, and 107, and case law interpreting these sections. These trust companies were banks for purposes of the Revenue &Taxation Code.

Apportionment: Once it was determined that a trust company was within the definition of a bank and therefore subject to the financial rate, it was necessary to determine the appropriate method of allocating and apportioning income. CCR Section 25137-4.1, (CCR Section 25137-4.2 for years beginning on or after January 1, 1996) provides guidance and rules for banks and financials. See Bank & Financial Handbook Section 1000, APPORTIONMENT FORMULA, for a discussion of CCR Sections 25137-4.1 and 25137-4.2.

The basic function of a typical bank is to loan money on which it earns interest. Therefore loans are included in the property factor because they represent earning assets, property that produces income. A trust company does not employ intangible capital as its principle source of income producing activity. In the case of a trust company, by definition a bank but not a financial corporation, there are no income-producing intangibles of the type contemplated by CCR Sections 25137-4.1 and 25137-4.2. The intangibles of a trust company are not income producing intangibles but represent the results of the income generated by the services performed by a trust company. Therefore the use of CCR Sections 25137-4.1 and 25137-4.2 for trust companies does not fairly represent the extent of the taxpayer's business activity in California.

R&TC Section 25137 and the applicable regulation allow a departure from the allocation and apportionment provisions of the Uniform Division of Income for Tax Purposes Act in limited and specific cases. These trust companies are included in those limited and specific cases, and application of the general apportionment factors described in R&TC Section 25128 and its applicable regulation best represent the extent of its business activity in California.
0104.1 **Historical Background**

The Bank of North America was chartered on January 7, 1782 in Philadelphia. It became the first chartered commercial bank in the United States. It was the first to issue paper that was convertible into coined money. By 1800, twenty-nine commercial banks were in operation in the U.S.

The federal government established the Bank of the United States in 1791. This bank served as the federal government's financial agent and had branches in most major cities. The existence of a central bank was a major political issue causing the bank to close in 1811.

Alexander Hamilton, the first Secretary of the Treasury, believed that a national bank licensed and supported by the federal government would assist the new nation. Other "Founding Fathers" feared concentration of capital within a few states.

The Second Bank of the United States was formed in 1816 to act as a central bank. Again due to opposition to a central bank, the bank was closed in 1836. All remaining banks were state chartered although some states owned and operated the banks.

The role of the federal government in banking was limited to minting coin. The individual banks printed their own paper money.

The first income tax legislation directed at banks was the Revenue Act of 1862 that was needed to pay Civil War expenses.

The Civil War created a demand for a stable and uniform currency. The National Bank Act was passed in 1863. It established national banks chartered and regulated by the federal government. The Office of the Comptroller of Currency, part of the U.S. Treasury Department, was created as the national bank regulator.

Only a small number of banks were organized under the National Bank Act of 1863, so Congress revised the law in 1864 to allow state-chartered banks to reorganize as national banks. To induce such reorganizations Congress included a tax of 10 percent of all notes of state banks paid out by any bank. The 1864 Act, by establishing a permanent bank system, also established a national currency.

The National Bank Act led to the terminology of the "dual banking system". The dual banking system refers to the fact that a bank may be state or federal chartered, and thus has different rights and restrictions.

The late 1800's and early 1900's saw the growth of state chartered banks. This period also saw a rapid growth in the nation's economy. The weakness of the National Bank Act was evidenced by:
• The state-chartered banks were beyond the control of the national government.
• The nation did not have an effective check collection and clearing system.
• The nation could not effectively control the supply of money.
• The reserve system was flawed. Many banks kept their reserves in a few national banks concentrated in New York City. The reserves were loaned short term. When the various banks needed additional funds they would draw on their reserves. The New York banks would have to call their loans in order to pay the reserve draw. This caused hardship throughout the entire economy.


The Federal Reserve System consists of a seven-member Board of Governors and twelve district banks. The Board of Governors sets the overall policy. National banks are required to be a member of the Federal Reserve System and maintain reserves in their district bank. California is within the 12th Federal Reserve System district.

The Federal Reserve System provides for:

- Centralized check collection and processing.
- The supply of coin and currency.
- The issuance, safekeeping, and redemption of U.S. government obligations.
- The control of the supply of money.
- The regulation and examination of member banks to insure that sound banking practices are followed.

The Fed controls the supply of money in the economy by:

- **Use of the discount rate.** Member banks borrow funds from the district bank. The discount rate is the rate of interest charged by the district bank to the member bank.

  If the Fed wants to decrease the amount of money in the economy they will increase the discount rate. The member bank will have to increase the interest rate they charge their customers since the bank's cost of funds is higher. Higher interest rates decrease borrowing.

  Likewise, the Fed may reduce the discount rate. This would decrease the cost of funds to the member bank, and accordingly, the interest rate charged to bank customers.
• **Use of reserve requirements.** Member banks are required to maintain reserves as cash in their vault and non-interest bearing accounts with the Federal Reserve District Bank.

  The Fed can reduce the amount of funds available for the bank to lend by increasing the reserve requirements. Likewise, the Fed can increase the supply of money by reducing the reserve requirements.

• **Purchasing and selling securities, usually U.S. government issued securities.** Funds are eventually deposited into commercial banks when the Federal Reserve buys government obligations. For example, ABC Insurance Co. sells $10 million of government securities to the Federal Reserve and deposits the money into a bank. The Federal Reserve may sell securities, thus reducing the supply of money.

By controlling the supply of money the Federal Reserve impacts the overall health of the economy including inflation, the value of the dollar in relationship to other currencies, and recessions.

What is money? Money is anything that can be used to purchase goods or services. Most people think of money as cash, i.e., coin and paper bills. Cash is also called currency. Yet, most purchases are made by check. A check is money as it can be used as money.

Bankers and economists refer to the money supply as M-1 (which is further divided into M-1A and M-1B) and M-2.

M-1A is defined as currency and demand deposits.

M-1B is defined as M-1A plus NOW and similar accounts. A NOW account is short for Negotiated Order of Withdrawal. This is an interest bearing transaction account such as a checking account. Congress first authorized NOW accounts in the Depository Institutions and Monetary Control Act of 1980.

M-2 is defined as M-1B plus time deposits in banks and thrifts and shares in money market mutual funds.

Business sections of the newspapers frequently report the change in the supply of money by stating the weekly or monthly change in M-1 and M-2.

Banks are one of the most regulated industries in the United States. The reason for this is the tremendous impact the banking industry has on the economy by their ability to create money through the multiplier effect of lending.

Assume a customer deposits $10,000 into a demand account such as checking, which has a reserve requirement of 10%. The bank has the authority to lend to $9,000 of that deposit. If the bank makes a
$9,000 loan by crediting another customer's account, then demand accounts have increased by $9,000 yet the amount of currency in the economy has not changed.

If the borrower pays another $9,000 for goods and services, then that person will deposit the funds in a bank. That bank now has the authority to loan $8,100 (90% of $9,000).

This is the concept of the multiplier effect of lending. The multiplier effect can be determined by dividing 1 by the reserve requirement, and then multiplying that result by the deposit amount. Our $10,000 deposit results in:

$$\frac{1}{10\%} \times 10,000 = 100,000.$$ 

The multiplier effect resulted in the bank creating $90,000 from the original $10,000 deposit.

The Federal Reserve System regulates member banks. Regulations issued by the Fed include:

- Regulation A establishes the conditions by which Federal Reserve Banks may extend credit to member banks.
- Regulation B prohibits discrimination by lenders on the basis of age, race, color, religion, national origin, or marital status.
- Regulation C requires annual public disclosure of the location of residential loans for those financial institutions that make federal related mortgages.
- Regulation D sets the bank’s legal reserve requirement.
- Regulation H defines membership and withdrawal requirements for state-chartered banks and procedures to attain approval of branches.
- Regulation J sets the terms and conditions for the collection and clearing of checks by the Federal Reserve.
- Regulation M establishes rules concerning foreign activities of member banks.
- Regulation Q controls the maximum interest that the bank can pay on time deposits.
- Regulation Z deals with truth-in-lending provisions.
The above is a summary of a few of the Federal Reserve's regulations in order to give the reader an idea of the degree of regulation by the Federal Reserve System. In addition, the Comptroller of the Currency has regulations.

The Revenue Act of 1913 adopted for the first time a permanent and comprehensive national tax on the net income of corporations, banks, and individuals.

The dual banking system (federal versus state charters) provided for unequal treatment of the different chartered banks because of the various state laws concerning branch banking.

The McFadden Act of 1927 placed federal and state banks on an equal footing by providing national banks the ability to branch bank to the same extent the law of a particular state allows state banks to branch.

Branch banking can be defined as a bank that has more than one full service office. California allows branch banking. Banks such as Bank of America or Wells Fargo Bank each have several hundred branches. Other states require that each branch be separately incorporated as a bank. Branch banking will be discussed further in this chapter.

Wall Street crashed in 1929 and the nation entered into a depression in the early 1930's. Thousands of banks failed in the 1930's and customers lost their deposits.

Newly elected President Franklin D. Roosevelt declared a "Bank Holiday" in March 1933. The closure of banks for a few days provided for a cooling off period in hopes that the run on deposits would stop.

To insure public faith in the banking system, Congress passed the Glass-Steagall Act of 1933. The key reforms of the Glass-Steagall Act were to separate investment banking from commercial banking and to create the Federal Deposit Insurance Corporation (FDIC).

Investment banking is the business of underwriting securities (stocks and bonds) for capital restructuring. For example, General Motors Corporation may wish to issue additional preferred stock. They may enter into a contract with an investment banker who will act as an intermediary to market the preferred stock.

Investment bankers are active in initial public offerings, secondary offerings, mergers, acquisitions, and leveraged buyouts. Major investment banks typically provide "firm commitment offerings", which means that the banker purchases the securities and sells them to investors. The investment banker has the risk of not being able to sell the securities or not being able to sell the security at the agreed value.

Commercial banking is the business of providing deposit, payment, and credit services to consumers and businesses. Of course, commercial banks may provide additional services.
Congress felt that investment banking was too risky for commercial banks. One provision of the Glass-Steagall Act was to prohibit commercial banks from underwriting securities and from investing in common stock for the banks’ own portfolio.

The Glass-Steagall Act does provide some exceptions for underwriting securities. Commercial banks may underwrite debt. Many large banks are dealers and market makers for government obligations.

Over the last few years the Federal Reserve has reviewed the request of certain well-capitalized banks and accordingly, now allows a few banks to underwrite equity securities.

The Federal Deposit Insurance Corporation (FDIC):

- Insures deposits of member bank customers up to $100,000. National banks are required to be a member of the FDIC. State chartered banks may join the FDIC deposit insurance.
- Promotes safe banking standards.
- Audits banks to ensure compliance with its standards.
- Prevents troubled banks from failing.

The Bank Holding Company Act of 1956 defined bank holding company and authorized the Federal Reserve to regulate the activities of the holding company.

The Bank Holding Company Act was amended in 1970 to limit the business activities of non-bank subsidiaries of the holding company. The amendment also allowed the Federal Reserve Board to decide which activities were permissible.

Banks and other financial institutions felt pressured to pay higher interest rates on deposits in the late 1970’s. One reason was the growth of money market accounts and mutual funds that paid higher interest. Many bank customers withdrew their deposits and placed the funds in other investments.

Congress responded with the Depository Institution Deregulation and Monetary Control Act of 1980 which:

- Allowed banks to compete for deposits by eliminating fixed (by the government) interest rates.
- Increased deposit insurance (FDIC) from $40,000 to $100,000.
- Opened Federal Reserve check clearing and collection services to outside competition.
• Authorized NOW accounts, which are interest bearing transaction accounts such as checking.

• Gave additional power to the Federal Reserve to control the supply of money.

The next major banking legislation was the Depository Institutions Act of 1982, which is also known as the Garn-St. Germain Act. This act provided additional authority and capital to rescue failed institutions, relaxed lending restrictions, and allowed new deposit instruments. The 1982 Garn-St. Germain Act amended the Bank Holding Company Act to prohibit banks from most insurance activities.

Among the provisions of the Competitive Equality Banking Act of 1987 was expanded authority for regulators in bank failures, mandatory check clearing requirements, and limitations on the growth of non-bank banks.

The most important banking legislation since Glass-Steagall in 1933 was the Financial Institutions Reform Recovery and Enforcement Act of 1989 (FIRREA). In regards to banks, the act:

• Allowed banks to acquire healthy thrifts and convert them to banks.

• Provided for certain levels of capital to be obtained by 1995.

Much of FIRREA deals with the savings & loan industry and will be discussed later in this chapter.

In the past, federal law prevented companies in the securities, bank and financial, and insurance industries from operating as members of a commonly owned affiliated group of corporations. The following changes in federal law during the 1990s resulted in federal deregulation of the financial services industry to allow a number of financial service businesses to operate under common ownership.

Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994

  o Permits banks and bank holding companies to purchase banks or establish subsidiary banks in any state nationwide.
  o Permits national banks to open branches or convert subsidiary banks into branches across state lines.

Gramm-Leach-Bliley Financial Modernization Act of 1999

  o Created a financial holding company that may engage in all authorized financial service activities.
  o Created a financial subsidiary for banks that can engage in most of the authorized financial service activities.
  o Newly authorized activities – securities, insurance, merchant banking/equity investment, "financial in nature", and "complimentary activities."
The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.

Various government agencies license, regulate, and audit state and federal chartered banks including:

- **State Superintendent of Banks**: Created by the California Legislature, administers the California Financial Code, licenses banks, performs compliance audits, and issues an Examiner's Report.

- **Federal Reserve Board System**: A quasi-government agency established by the Federal Reserve Board Act. It issues banking regulations, sets safe lending and reserve limits, acts as a source of funding, provides related services to the banking industry, makes compliance audits of its member banks, and issues confidential examiners' reports.

- **Federal Deposit Insurance Corp. (FDIC)**: A subsidiary of the Department of the Treasury—provides deposit insurance, and examines bank operations and loan reserves.

- **The Office of the Comptroller of The Currency (OCC)**: The OCC is part of the Treasury Department and is the oldest bank regulatory agency. The OCC is responsible for:
  - The approval of all charters, mergers and branches of national banks.
  - The supervision of national banks, including periodic examinations.
  - The receipt of extensive quarterly financial statements called "call reports".
  - **State/Federal Banking Laws**: Provides banking operation criteria, asset safety, nondiscriminatory loan guidelines, structures flexibility for conversions and mergers, and recent deregulation to stimulate money market competition.

- **Secretary of State**: Issues corporate state charters.
0108 STATE CHARTERED BANKS

- Licensed and regulated by State Bank Department
- Can take deposits
- Insured by FDIC
- Can be members of Federal Reserve Board
- Can have financial subsidiaries
- Can have branches within state only (see following section on interstate banking)
- Can file combined reports
- Can have International Banking Facility
- Can borrow/lend money
- Can be related to bank holding companies
- Can be privately or publicly held
0112    NATIONAL BANKS

- Federal chartered only
- Automatic Federal Reserve Board/FDIC members
- Can take deposits
- Can operate in multiple states and foreign countries through financial subsidiaries, i.e., Edge Act corporations and bank holding companies
- Can file combined reports
- Can have International Banking Facility
- Can borrow/lend money
- Can have offshore banking facilities (Cayman/Nassau/Bahamas)
- Can be related to bank holding companies
- Can be publicly or privately held
0116 FOREIGN INTERNATIONAL BANKS

- Multinational purpose of foreign banks is to promote business trade and international financing of parent country
- Can have agency/branch/representative offices in California
- Can be state/federal chartered
- Can form/acquire/ subsidiary full-service banks
- Can have financial subsidiaries
- Can be members of Federal Reserve System and FDIC
- Can have International Banking Facility
- Can take foreign deposits
- Can have offshore banking facilities (Cayman/Nassau/Bahamas)
- Can file combined reports
- Operate in multiple states/countries worldwide
- Can be privately, publicly, or government owned
0120  INTERSTATE BANKING

Bank & Financial Handbook Section 0120.1 - Federal Law
Bank & Financial Handbook Section 0120.2 - State Law
0120.1 Federal Law

Public policy as expressed by Congress over the past several decades has been one of opposition to nationwide interstate banking. The McFadden Act of 1927 permits national banks to establish and operate new branches to the same extent that state law of a particular state permits state banks to operate a branch banking system.

The intent of Congress in enacting the McFadden Act was to place national and state banks on an equal basis in regards to branch banking. Congress had concerns about the risks of banks expanding geographically too quickly. Also, Congress was concerned about the concentration of banking in large cities versus rural areas.

Unless specifically authorized by state law, the Douglas Amendment (Section 3(d) of the Bank Holding Company Act of 1956) prohibits the Federal Reserve Board from approving an application by a holding company to acquire a bank outside the holding company's principal state of operations.

The Bank Holding Company Act permits the following interstate bank activities:

- The ownership of companies that either accepts deposits or makes loans but not both without geographical limitations.
- To have loan production offices and national credit card solicitation.
- The ownership of investment banks, which are not subject to interstate limitations, but offer services similar to a traditional bank. The establishment of Edge Act corporations.
- Permits the twelve interstate bank holding companies that were in existence when the Douglas Amendment was passed to continue interstate banking.

Two recent developments have accelerated interstate banking. First, the Supreme Court in June 1985 upheld the constitutionality of a New England regional interstate banking agreement. Second, "non-bank" banks are engaging in many traditional banking activities outside the commercial domicile of the bank parent company. A non-bank bank is technically not a bank, as it does not offer both demand deposits and commercial loans.
0120.2 State Law

As you can see, the federal government placed the burden on the states in regard to interstate banking. Senate Bill 2300 and Assembly Bill 1492 was California's response to this burden.

Senate Bill 2300 effective July 1, 1987, provides for regional reciprocity. Regional reciprocity means:

- **Region**: Banks whose operations are principally conducted in Alaska, Arizona, Colorado, Hawaii, Idaho, Nevada, New Mexico, Oregon, Texas, Utah, or Washington.

  Principally conducted within a state is defined as the state in which the combined deposits of the bank holding company's subsidiary banks are largest.

- **Reciprocity**: The California Superintendent of Banks must find that the out-of-state banking organization's home state has substantially the same provisions concerning interstate banking as California.

  Assembly Bill 1492 effective January 1, 1991, eliminates the geographic restrictions of Senate Bill 2300 although still requires "substantial reciprocity". Both Senate Bill 2300 and Assembly Bill 1492 limit interstate banking to the acquisition of banks already located in California.

The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (H.R. 3841, P.L. 103-328), amends Section 3(d) of the Bank Holding Act of 1956 to allow state and nationally chartered banks to branch across state lines.
0124 FINANCIAL TAX RATE

The federal government restricted the authority of a state in taxation of nationally chartered banks. National banks are generally publicly traded and established for profit. They have been considered to be instrumentalities of the federal government because they obtained their charters from and performed limited functions for the federal government. Because of this, taxation of national banks by the state could only be to the extent specifically permitted by Congress. Since 1864, Congress has from time to time added methods of taxation originally made available for the states to tax national banks.

The states have been permitted to impose, in addition to taxes on real property, one or more of the following four taxes on national banks:

1. An ad valorem tax on the outstanding shares.
2. A tax on the dividends from the shares.
3. A tax directly on the net income of the banks.
4. A tax according to or measured by the net income of the banks, including income from tax-exempt federal securities.

California set up the franchise tax in 1929 and adopted #4 above.

The tax imposed on banks is in lieu of all other taxes and licenses (state, county, and municipal) except taxes upon real property (see R&TC Section 23182 for additional taxes); banks escape various other taxes which other corporations are assessed. If banks were assessed the same general corporate rate under R&TC Section 23151, the result would be substantial discrimination in favor of banks. To avoid such discrimination, the state adds an additional tax to the general corporate rate. The combined rate is termed the "bank" or "financial rate". It is the general rate plus a rate that is the percentage of all personal property taxes paid by other general corporations (excluding certain public utilities) to the general corporation's net income.

The 1969 amendments to the U.S. Code allowed most types of taxes on banks, so long as applied in a nondiscriminatory manner. This change permitted the various taxes listed in R&TC Section 23182 to be applied to banks.

In Security First National Bank vs. Franchise Tax Board, 55 Calif. 2d 407, the California Supreme Court held that the bank tax rate is not a violation of the federal restriction on taxation of national banks.

The Franchise Tax Board must determine the total amount of personal property tax paid by general corporations in order to calculate the financial tax rate. In the past this required the review of tax returns and sometimes a request for additional information. Due to this procedure the financial corporation tax rate was not known until after the tax returns of the bank and financial corporations were filed.
The law was changed for income years ending after 1991 to allow the Franchise Tax Board to use statistical sampling and alternative sources of information in order to have a less burdensome and more timely determination of the bank and financial corporation tax rate. The 1992 bank and financial tax rate was set in December 1991.

For years after 1994, the financial tax rate was set at a flat amount equal to 2% above the year’s general corporation tax rate.
SAVINGS AND LOAN ASSOCIATIONS

Savings & loan associations may have a federal or state charter.

Prior to 1989, Savings & loans that have a federal charter are required to be members of the Federal Savings and Loan Insurance Corporation and are governed by the Federal Home Loan Bank Board. State chartered savings & loans may elect to be covered by the Federal Savings and Loan Insurance Corporation, provided they adhere to federal requirements.

The 1989 Financial Institutions Reform Recovery and Enforcement Act restructured the thrift industry. These provisions include:

- The Office of Thrift Supervision replaced the Federal Home Loan Bank Board in supervising the restructuring of the thrift industry.

- The Federal Savings and Loan Insurance Corporation was abolished and deposit insurance responsibility was placed with the Savings Association Insurance Fund, which is an agency of the Federal Deposit Insurance Corporation.

- The Federal Housing Finance Board replaced FHLBB in regards to regulation of its member banks (FHLBB had twelve district banks similar to the Federal Reserve System).

- The Resolution Trust Corporation (RTC) was established to hold and liquidate assets of failed thrifts.

The State Savings and Loan Commission regulates state-chartered savings & loan associations.

The savings & loan industry ranks as the third largest financial industry in the United States. Only commercial banks and life insurance companies have greater assets.

The first few decades of the 19th century saw increasing numbers of people move to urban areas of the United States. These individuals needed financial institutions where they could save funds at a profit with safety. They also needed to finance home purchases. Traditionally, individuals borrowed money for their home purchases from savings & loan associations.

Commercial banks targeted trade and agricultural business activity as higher profits could be earned from those larger operations. The home loan demand quickly outpaced the ability of individuals to offer loans.

It is believed that the first savings & loan association in the United States was formed in Philadelphia in 1831. It was patterned after similar institutions in England. The savings & loan industry grew rapidly. In
response to this growth many states enacted laws for chartering and supervising savings & loan associations.

As the industry matured two characteristics evolved. First was the use of long-term fixed mortgage home loans; the second was the accumulation of small long-term individual savings accounts. A savings & loan association during this time generally took deposits and made loans within the same community.

Savings & loan associations were looked upon as benevolent institutions providing a public service because of their function of encouraging savings and making home loans. Accordingly, they received favorable tax treatment. The Revenue Act of 1913, which set up the first permanent national income tax on corporations and individuals, exempted savings & loan associations from federal income tax.

The 1920's were a period of industrial expansion and high levels of personal income. Correspondingly, savings & loan associations grew substantially. The industry changed from small cooperatives to major financial institutions. With growth, savings & loan associations set up permanent offices and large staffs.

The stock market collapse of 1929 was the beginning of a deterioration of the economy resulting in a depression over the next several years. The poor economic environment was reflected in the financial operations of banks and financial entities that suffered the withdrawal of deposits and the failure of borrowers to make loan payments. Many financial institutions closed their doors although the savings & loan industry had fewer failures than other financial institutions.

Legislation was sponsored by the new administration in Washington D.C. to build the confidence of depositors in savings & loan associations. Important legislation included:

- **The Home Owner's Loan Act of 1933**—Provided for the first time, federal chartered savings & loan associations. The chartering and regulation of these entities was the responsibility of a new organization, the Federal Home Loan Bank Board. The federal chartered savings & loan associations were required to be members of the Federal Home Loan Bank System and the Federal Savings and Loan Insurance Corporation.

  The Federal Savings and Loan Insurance Corporation was another new organization that had the responsibility of insuring deposits within specific limits.

- **The Federal Home Loan Bank Act of 1932**—Set up the Federal Home Loan Bank System. The bank system is under the supervision of the Federal Home Loan Bank Board, a three-member bipartisan body. Twelve regional banks were established to provide short and long-term loans to savings & loan association members. The Federal Home Loan Bank System is patterned after the Federal Reserve System.

  The Federal Home Loan Bank of San Francisco is the 12th district bank that includes California,
Arizona and Nevada.

- As the 1939 Internal Revenue Code again exempted their income from tax, favorable tax treatment continued for savings & loan associations.

Due to a scarcity of consumer goods and building materials during World War II, savings in all financial institutions, including savings & loan associations, increased rapidly. Since the associations could not make a large amount of mortgage loans they purchased government bonds.

After World War II savings & loan associations enjoyed a high rate of growth in both deposits and loans made. As savings & loans continued to develop, both in size and complexity, the financial community brought pressure to bring savings & loan associations under the federal income tax system, arguing equitable taxation.

Beginning in 1952, savings & loan associations were subject to federal income tax and filing requirements for the first time. However, the bad debt rules were so generous that few savings & loans incurred an income tax.

The Revenue Act of 1962 ended what appeared to be an income tax exemption enjoyed by savings & loan associations, although some favorable tax treatment did continue. The appearance of tax exemption was from a generous bad debt reserve. The reserve was based on a 20-year experience that included depression years. The bad debt provision substantially reduced the amount of taxable income.

The Tax Reform Act of 1969 subjected a greater amount of savings & loan associations' income to tax by including the following major provisions:

- Net bond gains were taxed as ordinary income. Under previous tax law gains were taxed at capital gain rates and losses as ordinary income.

- The deduction for bad debts was reduced.

- The bad debt deduction in excess of experience was classified as a tax preference item. The Tax Reform Act of 1976 raised the minimum tax rate from 10% to 15% and the minimum tax rate exemption was reduced.

The Tax Equity and Fiscal Responsibility Act of 1982 reduced the bad debt deduction, under the percentage of taxable income method, by disallowing 15% of the tax preference amount as a deduction. The Tax Reform Act of 1984 increased the disallowance from 15% to 20%.

Major changes brought about to savings & loan associations by the Tax Reform Act of 1986 include:
The cash method of accounting was denied for those savings & loans whose average gross receipts for the prior three years exceeded $5,000,000.

The percentage of income method of computing bad debt reserve was reduced to 8%, and the 20% of tax preference disallowance was eliminated.

The optional percentage of loan method used in computing the bad debt reserve was eliminated.

The computation of minimum tax was changed.

Savings & loan associations are subject to all provisions of the Internal Revenue Code as are other corporations, although IRC Sections 591 through 596 are special provisions for this industry.

Interest rates in 1979 and 1980 were extremely high. Savings & loans were in financial trouble as most of their loans were in long-term low interest mortgages while they had to pay high rates of interest to keep deposits. During these years the savings & loans were in a Catch-22 situation. They had to pay rates of interest to depositors in excess of the amounts they were loaning, or lose their depositors. Even so, billions of dollars were withdrawn from savings & loan associations.

Due to this crisis, the most important legislation for the savings & loan industry in fifty years was enacted, the Garn-St. Germain Depository Institutions Act of 1982, which:

- Increased business opportunities for savings & loan associations. Traditionally federal savings & loan associations were limited in the investments they could make by type of investment and percent of assets loaned by type of investment.

  While the Act provided for more liberal investment guidelines, investment opportunities were still limited in comparison to other financial institutions. For example, the Act allowed for the increase in the amount of assets invested in nonresidential real estate from 20% to 40% of the association’s total assets.

- Eliminated the advantage savings & loans had over commercial banks. They previously could pay .25% more interest on deposits, which encouraged greater savings in saving & loan associations.

- Granted the Federal Home Loan Bank Board and the Federal Savings and Loan Insurance Corporation new powers to deal with financially troubled savings & loans.

- Authorized emergency rescue programs to help troubled savings & loans.

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The second half of 1982 saw interest rates dropping, and by year-end savings & loan associations were receiving more in interest income than the interest expense they paid on deposits. During 1981 and 1982, 813 savings & loans disappeared, most of which were merged into other institutions.

Savings & loan associations continued to fail during the 1980's and early 1990's for various reasons including:

- Concentration of loans in a geographic region that was dominated by one industry and that industry was depressed. For example, Texas and Colorado are major energy states. Oil and gas companies were hurt by the fall in the price of oil in the early 1980's. This fall in prices caused high unemployment in the region. Unemployment caused defaults on residential loans and low occupancy for commercial rentals. Depressed real estate values greatly impacted savings & loan associations.

- Concentration of investments that were adversely effected by the economy such as junk bonds.

- Fraud.

The problems in the savings & loan industry caused:

- The passage of the Competitive Equality Banking Act of 1987 that provided additional capital to the insolvent FSLIC.

- The passage of the 1989 Financial Institutions Reform Recovery and Enforcement Act that was discussed at the beginning of this section.

The Small Business Protection Act of 1996 amended or repealed the following Internal Revenue Code provisions applicable to savings & loan associations:

- The denial of a portion of certain federal tax credits (IRC Section 50(d)).
- The reserve method of accounting for bad debts allowed by IRC Section 593 (for federal purposes, savings & loan associations then became subject to the same rules for the reserve method of accounting for bad debts allowed for banks by IRC Section 585).
- The special rules for the foreclosure of property securing a thrift institution’s loans (IRC Section 595).
- The reduction in the dividends-received reduction (IRC section 596).
o The ability of a thrift institution to use a net operating loss to offset its income from a residual interest in a real estate mortgage investment conduit (REMIC).

The Deposit Insurance Funds Act of 1996 included provisions to fully capitalize the Savings Association Insurance Fund (SAIF), reallocate payment of the annual Financing Corporation bond obligation, and to provide for the merger of the SAIF with the Bank Insurance Fund on January 1, 1999.
0132  FINANCIAL CORPORATIONS

Since a financial corporation is assessed at the bank tax rate, it is important for the auditor to know what a financial corporation is.

The classification of a corporation as a financial corporation was the response of the California legislature to federal law that prohibits discriminatory state taxation of a national bank as compared to other competitive financial entities. Assessment of tax at a different rate for national banks than financial corporations would be considered discriminatory.

Neither federal nor state law defines the term financial corporation. Crown Finance Corp. vs. McColgan, 23 Cal. 2d 280 (1943), Marble Mortgage Co. vs. Franchise Tax Board, 241 CAL. APP. 2D 26 (1966), and The Morris Plan Co. vs. Johnson, 37 Cal. App. 2d 621 (1940) are leading decisions in defining financial corporations.

The courts held that a financial corporation is one that deals in moneyed capital, as opposed to other commodities, in substantial competition with national banks. An example of a financial corporation is a savings & loan association.

The concepts of moneyed capital and substantial competition with national banks are interdependent. To be classified as a financial, the corporation must deal in moneyed capital that is in substantial competition with national banks. For example, a discount stock brokerage firm may allow customers to purchase stock through margin accounts. In margin purchases, the customer pays 50% of the stock purchase price and borrows the remaining amount from the brokerage firm. The firm charges interest on the margin account. The firm also offers interest-bearing accounts pending stock investments.

In this example, the discount brokerage firm competes in some aspects of the business of national banks. The firm takes deposits pending investment and loans funds on margin accounts, but is not in substantial competition with national banks as the majority of income is from fees charged for buying and selling stock on behalf of the customer.

The Franchise Tax Board issued CCR Section 23183 during 1991. The purpose of the regulation was to define "financial corporation". CCR Section 23183(a) defines a financial corporation as:

"a corporation, ..., which predominantly deals in money or moneyed capital in substantial competition with the business of national banks."

The regulation defines "predominantly", "deals in", "money or moneyed capital", "in substantial competition", and the "business of national banks".

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.
0132.11 Predominance Test

To be classified as a financial corporation, more than 50% of the corporation's income must relate to the employment of moneyed capital, i.e., interest income.

The auditor should not change a corporation's classification back and forth. Instead the auditor should look at all of the facts over a period of time and note the incidental or occasional sale of an asset or a change in business operations. For example:

- A savings & loan association sells its corporate headquarters. The gross receipts generated from the sale of the headquarters results in less than 50% of its income derived from dealings in moneyed capital. This event on its own is not enough to change the classification from financial corporation.

- A savings & loan association is concerned about the high rate of interest they must pay to keep deposits. Management decides to sell all mortgage loans, reduce the interest rate to discourage deposits and become a loan broker. The next year results in more than 50% of their income being derived from loan fees from acting as a loan broker, that is a middleman between the borrower and the unrelated lender. We must evaluate the taxpayer's classification given what appears to be a permanent change in business operations and change them to a general corporation.
0132.22 "Deals In"

Dealing in moneyed capital means trading in moneyed capital on one's own account. Funds may be obtained through issuance of stock, operating profits, or borrowing. These funds must be used for the purpose of dealing in moneyed capital.

For example, a corporation that receives fee income for document preparation and referral of the customer to an unrelated bank is not a financial.
0132.33 "Money Or Moneyed Capital"

The regulation provides examples of moneyed capital such as coin, currency, mortgages, etc.
0132.44 "Substantial Competition"

To be in substantial competition with national banks, the predominant activity by the corporation must be of a general line of business that national banks engage in.

The Appeal of Arc Investment Co. (SBE) (1964) held that the corporation was not a financial. Arc Investment Co. discounted commercial paper. The commercial paper was of a type or class that would not be acceptable to national banks as a credit risk.

In the Appeal of Atlas Acceptance Corp. (SBE) (1981), the Board expressly rejected the argument made in Appeal of Arc Investment, that lack of competition with respect to a particular type of commercial paper was essential. The board found that the taxpayer was in fact a financial corporation despite the fact that it dealt in different classes of commercial paper.

"In Arc Investment, no mention was made of the United States Supreme Court decisions in First Nat. Bank vs. Hartford, supra, and Minnesota vs. First Nat. Bank, supra. Similarly, as in the Appeal of Atlas Acceptance Corp., the California Court in Crown Finance Corp vs. McColgan, (1943) 23 C2d 280 held that even though there was a difference in terms of conditional sales contracts from those employed by national banks, Crown was in substantial competition with national banks. The United States Supreme Court decisions cited above affirm the proposition that it is not necessary to show that national banks and competing investors solicit the same customers for the same loans or investments. But it must be shown that competing investors make the same type of investments made by national banks, e.g., the discounting of commercial paper. "Thus, by focusing on the lack of competition with respect to the particular type of commercial paper purchased by Arc Investment Co., as opposed to commercial paper generally, the opinion in Appeal of Arc Investment Co. was in error", Appeal of Atlas Acceptance Corporation, July 29, 1981.

Atlas argued that banks, within the taxpayer's locality, had a policy against purchasing accounts receivable of the nature purchased by Atlas Acceptance Corp. due to the risk. The Board rejected this argument and held that substantial competition means doing business of a general activity that is also engaged in by national banks. Thus the fact that Atlas was in the business of discounting commercial paper, an activity also engaged in by national banks, made the taxpayer in substantial competition.
0132.55 "Business Of National Banks"

The business of national banks is defined as the business activities in which national banks are permitted. The Federal Reserve System and the Office of the Comptroller of the Currency regulate national banks. The Fed and the OCC have detailed rules and regulations concerning permissible activities of a national bank.

The national bank law can be found in 12 U.S.C. (United States Code), which should be in a law library.

Fed and OCC regulations can be found in the Code of Federal Regulations. If you have access to Lexis you would enter the library "GENFED" and the file "CFR" for the Code of Federal Regulations.

The Fed has libraries at their regional boards and branches. The location of some of the regional boards and branches are:

**District 2**
Federal Reserve Board of New York
33 Liberty Street
New York, New York

**District 7**
Federal Reserve Board of Chicago
230 South La Salle Street
Chicago, Illinois

**District 11**
Federal Reserve Board of Dallas
400 South Akard Street
Dallas, Texas

Houston Branch
1701 San Jacinto Street
Houston, Texas

**District 12**
Federal Reserve Board of San Francisco
101 Market Street
San Francisco, California
Los Angeles Branch
409 West Olympic Boulevard
Los Angeles, California

The auditor should call their local Federal Reserve district or branch office concerning the location of the Fed library, hours, and access.

The OCC is located in Washington D.C.
0136 FINANCIAL CORPORATION ACTIVITIES V. GENERAL CORPORATION ACTIVITIES

The auditor may have to determine which entities are financial corporations versus general corporations in a combined report. For example, a unitary group may have the following corporate structure:

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Savings & Loan Association
  ↓     ↓     ↓     ↓
Real Estate Developer  Financial Leasing  Computer Services  Escrow Company
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The dominant activity of the unitary group is the savings & loan. The computer services and escrow companies were spun out of the savings & loan as part of a reorganization of the group.

Most of the business operations of the computer services and escrow companies are inter-company.

The savings & loan association deals in moneyed capital and is in substantial competition with national banks. Thus, the savings & loan association would be classified as a financial corporation.

Problems may arise when divisions of a financial corporation are spun out as subsidiaries.

Although the computer service and the escrow companies are activities in direct support of the savings & loan association, the entities are not dealing in moneyed capital. These entities would be classified as general corporations, even though their activities are activities that the savings & loan association could do had they not spun them out to form separate corporations. The determination of financial corporation status must be done on an entity-by-entity basis.

The leasing corporation would be classified as a financial corporation if the leases were in the nature of a financial arrangement instead of true operating leases. Leasing corporations will be discussed in more detail later.

The real estate developer would most likely be classified as a general corporation. An exception would be if a financial corporation repossessed a development project that is near completion and spins the repossessed assets into a subsidiary, which will act as general contractor to complete the real estate project for eventual sale.
0140 OTHER TYPES OF FINANCIAL CORPORATIONS

Bank & Financial Handbook Section 0140.1 – Loan or Mortgage Company
Bank & Financial Handbook Section 0140.2 – Credit Card Company
Bank & Financial Handbook Section 0140.3 – Credit Unions
Bank & Financial Handbook Section 0140.4 – Small Business Investment Companies
Bank & Financial Handbook Section 0140.5 – Farm Credit Administration
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0140.1 Loan Or Mortgage Company

These are corporations whose principle income is from making personal loans or real estate loans secured by trust deeds from their own moneyed capital.
0140.2 Credit Card Company

The State Board of Equalization held that a credit card company was taxable as a financial corporation because the corporate business was to deal in moneyed capital and was in substantial competition with national banks.

A department store may offer credit cards. Since the predominant activity of the department store is retail sales and not interest income, the department store would be a general corporation. The department store may have a subsidiary whose only business activity is the unitary group’s credit card operation. The subsidiary would be a financial corporation. This could be true for auto manufacturers, companies engaged in retail gasoline sales, and other entities.

See Bank & Financial Handbook Section 0908, COMBINATION OF GENERAL AND FINANCIAL CORPORATIONS.
0140.3 Credit Unions

The California credit union law defines a credit union as "a cooperative corporation, organized for the purposes of promoting thrift among its members, creating a source of credit for them at legal rates of interest for provident purposes, and providing an opportunity for them to use and control their own money on a democratic basis in order to improve their economic and social conditions."

Credit unions have either state or federal charters.

Federal-chartered credit unions are not taxable under the California Revenue and Taxation Code.

Operative for income years beginning on or after 1/1/99, SB 934 added R&TC Section 23701y to Chapter 4 of the Revenue and Taxation Code. That section provides for the exemption from tax of state-chartered credit unions.

Prior to 1/1/99, state-chartered credit unions were found to be in substantial competition with national banks though they restrict their membership. They were taxed as financial corporations.

They were allowed a deduction for all income resulting from or arising out of business activities with members or when done on a nonprofit basis for or with non-members as provided in R&TC Section 24405(a).

Prior to income year 1988, income from investments in bonds, savings deposits, etc., with non-members was held not deductible. The courts looked at the transaction to determine if the income was member or non-member income.

AB 1581 (Stats. 1987, Ch. 1465) added subsection (c) to R&TC Section 24405, effective for income years beginning on or after January 1, 1988. R&TC Section 24405(c) provides for the deduction in computing taxable income, the income from credit union "surplus member savings capital". "Surplus member savings capital" is defined as the savings capital of the credit union members, which is in excess of the amount of savings capital loaned to its members.

AB 1581 (Stats. 1987, Ch. 1465) does not define income from surplus member capital or how to determine the amount of income. FTB Notice 92-7 provides direction in how you determine the amount of income from surplus member capital. FTB Notice 92-7 also concluded that credit unions were subject to Alternative Minimum Tax.

Legislation in 1993 provided that credit unions were not subject to AMT from member income. This resulted in regular tax equaling alternative minimum taxable income, thus no AMT.
The 1993 legislation also provided that income from a reciprocal credit union is member income deductible under R&TC Section 24405(a).

The 1993 AMT and reciprocal credit union legislation was retroactive to all open years.
0140.4 Small Business Investment Companies

0140.5  Farm Credit Administration

Congress established the Farm Credit Administration in 1933 to consolidate within one entity substantially all powers and responsibilities of the federal government dealing with agricultural credit. The Act also provided additional resources for farm credit and formed the cooperative system of farming still in existence.

The Farm Credit Administration is an independent federal agency under management of a three-member board of directors appointed by the president.

The Farm Credit Administration divided the United States into twelve Farm Credit Districts. Each district has a:

- Federal Land Bank that makes loans for general agricultural purposes.
- Federal Intermediate Credit Bank that provides seasonal credit for farmers and ranchers.
- Bank For Cooperatives that provides loans to eligible cooperatives owned and controlled by farmers, ranchers, and producers or harvesters of aquatic products or furnishing farm supplies or services.
- Production Credit Associations that are local cooperatives and make loans for general agricultural activities.

Bank For Cooperatives and local Production Credit Associations are not federal government entities. They are owned by their membership, thus are subject to the Revenue and Taxation Code. Since they are cooperatives, they are not taxed on member income as provided by R&TC Section 24405.
0140.6 Leasing Corporations

The Comptroller of the Currency in a letter dated March 18, 1963, informed the presidents of national banks that direct lease transactions are "a lawful exercise of the powers of a national bank. It is our conclusion that direct leasing transactions constitute legal and proper banking activities for national banks".

Prior to 1963, national banks were not permitted to directly engage in leasing. Accordingly, prior to 1963, the Franchise Tax Board would not classify a leasing corporation as a financial since they were not in substantial competition with national banks.

Prior to 1963, national banks would make loans to leasing companies in which the security for the loan was the leased property. Starting in 1963, the Office of the Comptroller of the Currency allowed national banks to lease directly with the lessee rather than through a leasing company.

The California State Banking Department’s Superintendent of Banks allowed state chartered banks to engage in direct leasing in 1964.

The Franchise Tax Board revised its position in regards to leasing companies due to the above changes in bank regulation. Certain leasing companies can be classified as financial corporations because national banks are permitted to engage in direct leasing.

In the Appeal of Avcar Leasing, Inc., (SBE), March 31, 1982, the Board of Equalization considered the issue of whether a corporation engaged in the business of leasing automobiles was a financial corporation. The taxpayer did not maintain an inventory of automobiles. Avcar Leasing, Inc. asked the potential customer to choose their car, which would be procured at the time of the lease. The customers were screened as to their credit worthiness and the customer was responsible for the maintenance, repair, licensing, registration, and insuring of the leased vehicles.

The Board concluded that the leases were functionally interchangeable with secured loans in substantial competition with national banks, and that the taxpayer was properly classified as a financial corporation.

Federal Accounting Standards Board Statement #13 provides guidelines for financial accounting purposes and Rev. Rul. 55-540 provides guidelines for tax purposes in determining if a lease is in fact a financing arrangement. Basically leases are classified as operating leases or capital leases. The following chart will help distinguish between the two types of leases:
0140.61 Operating Lease

Lessee:
- Rental payments

Lessor:
- Rental income
- Asset on balance sheet
- Depreciates asset
0140.62 Capital Lease

Lessee:
- Principal & interest payments
- Asset on balance sheet
- Depreciates asset

Lessor:
- Interest income or sale

Capital leases for the lessor may be divided into sales-type leases and direct-financing leases. The difference between the two is that sales-type leases include profit from manufacturing while direct financing leases includes interest and principal only.
0140.63 Sales Lease

Ace Corporation manufactures product z. You want to purchase product z and agree to lease it under terms that qualify as a capital lease. Your monthly lease payment to Ace Corporation includes Ace Corporation's cost to manufacture the product, interest and Ace Corporation's profit on the product sale.
0140.64 Direct Financing Lease

You want to purchase product z from Ace Corporation. You enter into a lease agreement with Federal Safe and Secure Bank that under the terms qualifies as a capital lease. At the beginning of the loan, Ace Corporation is paid its cost of production and profit by Federal Safe and Secure Bank. Federal Safe and Secure Bank receives principal and interest payments from you.

In November 1976, the Financial Accounting Standards Board issued FASB No. 13. It provides that for book purposes a lease will be treated as a financial transaction, if any of the following four transfer of ownership tests are met:

1. Ownership transfers at the end of the lease.
2. The asset can be purchased for a nominal amount (less than fair market value) at the end of the lease.
3. The term of the lease exceeds 75 percent of the property's estimated economic life.
4. The present value of the minimum lease payments exceeds 90 percent of leased equipment’s fair market value, less any investment credit retained by the lessor.

The Internal Revenue Service in Rev. Rul. 55-540 set guidelines for determination if a transaction was indeed an operating lease. The test for determining if a lease agreement is in substance a purchase is whether the lessee acquires from the lessor the predominant benefits and burdens of ownership during substantially all of the leased property’s useful life. The conditions listed in Rev. Rul. 55-540 should be studied in detail if the auditor must determine if a lease is an operating or capital lease.

In Rev. Proc. 75-21 the Internal Revenue Service established guidelines for advance rulings if a transaction was a sale or lease for tax purposes. If the following are met the IRS will likely rule that the transaction is a lease:

- The investor group must have a 20-percent equity at all times in the property.
- The lessee must not finance or guarantee financing for the equipment.
- The purchase option at the end of the lease cannot be less than the fair market value of the property.
- The lessor must be able to show a profit from the transaction absent of tax benefits.

The fair market value at the end of the lease must be at least 20% of the original cost and a remaining useful life longer than one year or 20% of the original useful life.
Much of the federal tax law concerning leasing was developed by the courts and not in the Internal Revenue Code. Congress enacted statutory lease guidelines as part of the Economic Recovery Tax Act of 1981 (ERTA). Taxpayers following ERTA’s "safe-harbor" provisions were assured that their transaction would be treated as a lease.

California did not adopt the safe-harbor provisions of ERTA. For additional information on the state treatment of safe-harbor leases please see MATM 6086.

Criticism of ERTA's safe-harbor leasing rules prompted Congress to repeal the safe-harbor provisions in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), and a new set of leasing rules were adopted. However, the Deficit Reduction Act of 1984 deferred the effective date of the new leasing rules until January 1, 1988 and the Tax Reform Act of 1986 eliminated the new rules, known as finance leases for the most part.

Currently federal and state law uses the test of Rev. Rul. 55-540 and various court cases to determine if a transaction is a lease, the same procedure prior to adoption of ERTA's safe-harbor provisions.

AB 66 (Stats. 1979, Ch. 1150), dated September 29, 1979, added R&TC Section 23183(b). R&TC Section 23183(b) provides that a financial corporation does not include any corporation, including a wholly owned subsidiary of a bank or bank holding company, if the principal business activity of such entity consists of leasing tangible personal property.

In reading R&TC Section 23183(b), you may question if the law applies to both operating and capital leases or only to operating leases. The Department answered the question in FTB Notice 91-4.

FTB Notice 91-4 concludes that R&TC Section 23183(b) is ambiguous because the term leasing is not defined. Given the ambiguity, you must look to legislative intent rather than to the law section alone.

The legislative intent is expressed in the uncodified preamble of AB 66, which was to reaffirm the legislature’s long-standing purpose of ensuring "competitive parity" and "equal treatment" of banks and financial corporations. To assess a corporation whose principal business activity consists of leasing tangible personal property in substantial competition with a national bank at a rate of tax that a national bank would pay, would frustrate the legislature’s intent of competitive parity and equal tax treatment.

Legal Ruling 94-2 superseded and withdrew FTB Notice 91-4. Legal Ruling 94-2 incorporates the analysis and conclusions of FTB Notice 91-4. In addition, Legal Ruling 94-2 provides a definition of finance lease. A finance lease, for the purposes of determining whether a corporation is a financial corporation, is a lease that is the type of lease allowed to national banks and is economically equivalent to the extension of credit. The lease is not treated as a true lease for federal income tax purposes. For example, the lessor is not entitled to a deduction for depreciation.
National banks are restricted by the OCC in the nature of the leasing they can do. For example, a national bank cannot enter into a vehicle lease that includes a maintenance contract.

Auditors should be aware of the *Appeal of Avcar Leasing, Inc.*, March 31, 1982. The question before the Board was if a leasing corporation was a financial corporation for 1977. The Board held that the leasing corporation was a financial although the Board added the following footnote:

"4) Pursuant to subdivision R&TC Section 23183(b), operative for income years beginning on or after January 1, 1979, appellant would apparently no longer qualify as a financial corporation."

The Franchise Tax Board petitioned for rehearing to have Footnote 4 stricken from the opinion. Petition for rehearing was denied.

Footnote 4 of the *Appeal of Avcar Leasing, Inc.*, does not clearly establish that the finance leasing activities subject the taxpayer to either the financial or general tax rate.

See also *Appeal of Alameda Bancorporation, Inc., Alameda First National Bank, First Leasing Corporation*, (SBE), March 9, 1995, where it was determined that First Leasing Corporation’s transactions are conditional sales and not leases. This case provides a thorough analysis of the factors relating to the benefits and burdens of ownership, in determining whether a transaction is an operating lease or a financing arrangement.
0140.7 Edge-Act Corporations

These are domestic corporations organized for the purpose of foreign banking or other international or foreign financial operations. They are federal chartered under a special section (12 U. S. C. A. 614) of the United States Code, and need not qualify with the Office of the Secretary of State.

An Edge-Act bank should be combined with its parent bank based on virtual certainty of unity. An Edge-Act bank is always in a state other than the state where the parent bank is located. After a 1978 amendment to the U.S. Code, an Edge-Act bank may operate in more than one state (formerly, the parent must have had a separate Edge-Act bank for each state where desired).
0140.8 International Banking Facility

R&TC Section 23044 defines an International Banking Facility (IBF). An IBF is a set of asset and liability accounts on the books and records of a commercial bank that may engage in limited international activities as provided by federal law.

At the federal level the purpose of the IBF was to allow U.S. banks to be competitive with foreign banks in international markets without sovereign risks.

California adopted R&TC Sections 23044 and 25107 so California banks would be competitive with New York banks, which already had similar legislation.

As provided by federal law, an IBF may only take deposits from a foreign entity, including a foreign subsidiary of an U.S. bank or corporation, nonresidents, or another IBF. The IBF may only make loans to another IBF, or foreign bank or foreign operations of an U.S. corporation provided that the funds are for use overseas.

R&TC Section 25107 treats the IBF physically located in California as "considered located without the state." The intangible personal property and sales (accounts receivable and interest income) reflected on the IBF’s separate books are excluded from the numerator of the apportionment factor.
0200 DEFINITION OF TERMS USED IN THE BANKING AND FINANCIAL INDUSTRIES

The following terms are commonly used within the banking and financial industries. References to them will also commonly be found in the Revenue and Taxation Code and Regulations adopted by the Franchise Tax Board.

ACCRETION
Accretion is straight-line inclusion of bond discount or premium in income or expense.

ACCRUED INTEREST TO DATE OF FORECLOSURE
See DELINQUENT INTEREST TO DATE OF FORECLOSURE.

AD VALOREM
Designates an assessment of taxes against property.

ADD-ON INTEREST
Type of loan in which interest is added to the principal amount of the loan made to the borrower. See also DISCOUNT.

AGENCY
Acting on behalf of other parties. Banks are commonly made agents for the collection and remittance of claims, notes, lease payments and the negotiation of loans. See also BRANCH.

AMERICAN BANKERS ASSOCIATION (ABA)
The national organization of banks formed in 1875 to promote the general welfare of the industry.

APPRAISAL
A property valuation.

ARBITRAGE
Simultaneous purchase and sale of foreign exchange, stocks, bonds, silver, gold or other commodities in different markets to profit from rate differences.

ASSET-BASED FINANCING
Borrowing funds that are secured by the expected value or cash flow from receivables, inventory, personal and real property.

AUTOMATED TELLER MACHINE
An electronic terminal that allows bank customers to perform transactions 24 hours a day.

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BAD DEBT EXPERIENCE
The loss experience based upon a moving average.

BAD DEBT LOSS
A loss realized on a loan of funds.

BAD DEBT PROVISION
See PROVISION.

BAHT
The currency or monetary unit of Thailand.

BALBOA
The currency or monetary unit of Panama.

BANK CHARTER
A document of incorporation from the state or federal government allowing a group to establish a bank.

BANK EXAMINATION
An audit by representatives of a federal or state regulatory agency to make certain that the bank is solvent and is operating in conformity with banking laws and sound banking principles.

BANK EXAMINER
A person who is a representative of the federal or state regulatory agency and performs the bank examination.

BANK HOLDING COMPANY
A person or company which owns or controls (1) 10% or more of the common stock of any domestic (state chartered) bank or (2) 10% or more of the outstanding guaranteed stock of any domestic bank together with 10% or more of the common stock of any national bank or (3) controls the election of a majority of the directors of any domestic bank or controls the election of a majority of the directors of both a domestic bank and any national bank located in California. The purpose of the bank holding company act is to define what non-banking activities can be conducted through a bank or its subsidiaries.

BANK
A taxpayer that is not a corporation but is taxable under Chapter 2 of the Bank and Corporation Tax Law. In the case of national banks, a bank is an agency of the United States. It is also defined under
the Internal Revenue Code as a bank or trust company doing business in the U.S. with a substantial part of its business being receiving deposits and making loans.

BANKER’S ACCEPTANCE
Banker's Acceptance is an order to pay a specified amount at a future date. (Similar to a line of credit.) Frequently used in the export/import business. For example, a U.S. importer wants to import clothes from Mexico and pay for them in 3 months (after he has had time to sell them). Bank A provides the bankers' acceptance or line of credit to the importer. The importer, using the line of credit draws a draft and gives it to the supplier. The supplier may then discount the draft at their bank for immediate payment. The Mexican bank can then present the draft to the U.S. bank. The U.S. bank may pay it off immediately at a discount or the Mexican bank may hold it to maturity (three months). After three months the importer pays the bank.

BASIS POINTS
1/100 of a percentage point is equal to one basis point. For example, .25% is 25 basis points.

BLOCKED CURRENCY
The conversion of one currency into another foreign currency is prohibited by law.

BOLIVAR
The currency or monetary unit of Venezuela.

BOLIVIANO
The currency or monetary unit of Bolivia.

BOND
A corporate promissory note or agreement to pay interest and principle to the bondholder.

BRANCH APPLICATION COSTS
Capital costs incurred in opening a branch office.

BRANCH BANK
Branch banking is a form of multiple-office banking whereby a bank that is a single entity operates more than one office. Branch banks include any branch office, branch agency, additional office or any branch place of business where deposits are received, checks are paid, or money is lent. A branch bank is a separate and distinct business entity though not a separate legal entity. A branch may be an agent of its parent bank.

BRANCH OFFICE
A commercial office of a bank or financial corporation. See also BRANCH BANK.
BRETTON WOODS AGREEMENT OF 1944
Representatives of 44 nations met at Bretton Woods, New Hampshire to adopt an agreement on international monetary concerns. The International Monetary Fund (IMF) and International Bank for Reconstruction and Development were created. Periodic meetings have been held to amend the original agreement.

BUNDESBANK
The central bank of Germany, formed in 1875.

BUSINESS LICENSE TAX
A tax paid to local jurisdictions for the permission to do business.

BUSINESS SITUS
The place at which intangible personal property is employed as capital or the place where the property is located if possession and control of the property is localized in connection with the taxpayer's business so that substantial use or value attaches to the property.

BUY-DOWN
A buy-down is a subsidy which is paid by the seller of real or personal property to the bank or financial corporation to compensate the institution for offering a lower than market interest rate to the borrower. The buy-down will normally cover a period of one year to five years. The buy-down represents a non-refundable payment to the institution that covers the difference between the payments that would be received at the prevailing interest rate and those received at the buy-down rate over the period of the buy-down.

CALL REPORT
A call report is a generic term used to refer to reports made to regulatory agencies such as the Comptroller of the Currency.

CAP LOAN
A variable interest rate loan with an interest rate limit.

CAPITAL
The shareholder's ownership in a corporation. Generally, capital includes common and preferred stock and retained earnings. Banks also include certain types of debts and reserves in capital.

CAPITAL ADEQUACY RULES
Federal regulations that require banks to maintain capital equal to a certain percentage of their loans.

CAPTIVE FINANCIAL
A financial corporation (or bank) that is a member of a unitary group in which the dominant activity of
the unitary group as a whole consists of general business activities (as opposed to financial corporation activities).

**CASH**
Currency, checks, banker's drafts on hand, and deposits.

**CEILING**
A limit to the amount of reserve for bad debts—usually calculated through the use of a multiplier or based on the reserve balance existing in a particular year.

**C.D.**
See CERTIFICATE OF DEPOSIT.

**CERTIFICATE OF DEPOSIT (C.D.)**
A certificate or note evidencing a deposit of money, for a fixed period of time, at a stated rate (usually fixed for the period of the deposit), with penalties for early withdrawal of the funds.

**CHARGES TO RESERVE**
Amounts applied against the reserve for bad debts upon realization of a loss previously provided for through a bad debt provision.

**CHARTER CITY**
A city that derives its powers directly from the state constitution. It therefore claims that the legislature may not impinge on its right to tax (business license taxes on financial corporations). The California Supreme Court in California Federal Savings and Loan Association vs. City of Los Angeles, 54 Cal 3d 1, 283 Cal Rptr 569 (1991) held that the state legislature had the right to limit the ability of charter cities to assess taxes against financial institutions.

**COLLATERAL**
Security provided by the borrower to protect the lender from loss. For example, your mortgage is secured by your house thus the house is the collateral.

**COMMERCIAL BANK**
A bank that provides deposit, payment and credit services to businesses and individuals.

**COMMERCIAL DOMICILE**
The location at which the principal business office is located or from which the business is controlled.

**COMMERCIAL LOAN**
A loan from a commercial bank to a business. The terms of the loan vary depending on the economy,
the ability of the business to repay the loan and past business dealings between the business and the bank.

COMPTROLLER OF THE CURRENCY
The Comptroller of the Currency is responsible for supervising national banks. He or she is appointed by the president and confirmed by the Senate. The agency examines, charters and liquidates national banks.

CONSTANT INTEREST RATE METHOD
The constant interest rate method is an accounting method used in computing the current inclusion in income of original issue discount.

CORE DEPOSIT
A capital value ascribed by a bank or financial corporation to specific assets acquired in the acquisition of another bank or financial corporation. These assets typically represent the intangible value of the depositor base acquired and are often claimed by taxpayers to be amortizable.

CORRESPONDENT BANKS
Independent banks which provide or receive services from each other. Many services such as check collection and credit card and data processing require a critical mass in order to be cost effective. Smaller banks will frequently contract such services to larger banks. Smaller banks may also contract to larger banks for investment advice. Smaller banks may also enter into participation loans with larger banks, as they may not have the expertise to evaluate the loan. A smaller bank may also wish to enter into a participation loan to avoid concentration of receivables from one customer or geographic area.

CORRESPONDENT OFFICE
An office located in a jurisdiction (usually foreign) in which the bank or financial corporation is not doing business and operated by an unrelated party.

COUPON STRIPPING
The sale of accrued interest on a loan, CD, or participation certificate to another bank or financial corporation. See also STRIPPED BOND AND SALE OF FUTURE INTEREST.

CREDIT CARD
A plastic card that allows the holder to borrow against a line of credit to purchase goods or services.

CREDIT UNION
A type of financial corporation. A cooperative group that specializes in the pooling of the savings of its members and making funds available through personal and mortgage type loans.

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CURRENCY
Term given to paper money and coin issued by the government or central bank, which circulates as the legal medium of exchange.

DEALER'S RESERVE
A reserve set up by a retailer with a bank or financial corporation to guarantee collections on finance agreements factored with the bank or financial corporation.

DEFAULT
A loan becomes a default when attempts at collection are not successful.

DELINQUENT LOANS
A loan that is overdue.

DEFERRED INTEREST
See ODD DAYS INTEREST.

DEFERRED LOAN FEE
Loan fee income, such as "points" which is recognized over the life of the loan by a bank or financial corporation. See also LOAN LIQUIDATION.

DELINQUENT INTEREST TO DATE OF FORECLOSURE
Interest income owed to a bank or financial corporation at the time of foreclosure on the property.

DEMAND DEPOSIT
A deposit into a checking or savings account which checks can be drawn on or funds removed without any advance notice.

DEBIT CARD
A plastic card that allows the bank customer to withdraw cash or make cashless purchases at businesses that have automated teller machines.

DEPOSITS
Money or the equivalent of money placed in the custody of a bank or financial corporation.

DINAR
The monetary unit of Abu Dhabi, Aden, Algeria, Bahrain, Iraq, Jordan, Kuwait, Libya, South Yemen and Tunisia.

DIRECT LEASE
A lease transaction in which the lessor provides the funds required to purchase the equipment.

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The monetary unit of Morocco.

**DISCOUNT**
The amount charged as interest on a loan, and in the usual case deducted by the bank or financial at the time of making the loan from the face of the borrower’s note. The difference between the face of the note and the deduction is paid to the borrower.

**DISCOUNT RATE**
The rate charged by the Federal Reserve System for short-term loans to meet reserve requirements.

**DM**
See DEUTSCHE MARK.

**DEUTSCHE MARK**
Germany’s currency.

**DOLLAR**
The monetary unit of the United States. The dollar is also the monetary unit of Antigua, Australia, Bahamas, Barbados, Belize, British Honduras, Brunei, Canada, Dominica, Fiji, Grenada, Guiana, Guyana, Hong Kong, Jamaica, Kiribati, Liberia, Monstserrat, Nauru, Nevis, New Guinea, New Zealand, Singapore, Samoa, St. Kitts, St. Lucia, St. Vincent, Taiwan, Trinidad and Tobago, Tuvalu and Zimbabwe, Guam, the Marshall Islands, Puerto Rico, and the U.S. Virgin Islands.

**DOMINANT FINANCIAL**
The predominant activity of a group of unitary taxpayers (including corporations, banks and financial corporations) is of a financial corporation nature (i.e. in substantial competition with national banks).

**DOMINANT GENERAL**
The predominant activity of a group of unitary taxpayers (including corporations, banks and financial corporations) is of a general nature (i.e. non-financial corporation).

**DRACHMA**
The monetary unit of Greece.

**DUAL BANKING SYSTEM**
Banks in the United States may have state charters (chartered by the bank’s home state) or federal charters (chartered by the U.S. government), thus creating two, or dual chartering systems.
EARLY WITHDRAWAL PENALTIES
Penalties mandated by regulatory authorities on the early withdrawal of CD's by depositors. Also known as a "1017 adjustment" (named after IRC §1017).

EDGE ACT CORPORATION
A corporation organized for the purpose of foreign banking or other foreign financial corporation operations with approval required only by the Board of Governors of the Federal Reserve System. It can establish branches anywhere in the U.S. without approval of any other federal or state agency.

ELECTRONIC BRANCHES
Automated Teller Machines (ATM) or point- of-sale terminals.

ELECTRONIC FUNDS TRANSFER
Any transfer of funds other than a transaction that is originated by a paper instrument that is initiated by electronic terminal, phone, etc.

For example:
- Point of sale transfers
- Automated teller transactions
- Direct deposits electronically of funds, such as Social Security or salary payments
- Wire transfers between banks
- Transfers for the purchase or sale of securities

ELIGIBLE LOAN BASE
Loans outstanding at the end of the year, exclusive of all amounts that are insured, guaranteed or otherwise established to be not at risk. Used in computing the bad debt provision for California purposes.

ENTERPRISE TAX
A tax based on income assessed against institutions doing business in Japan.

EQUITY LEASE
See OPERATING LEASE.

EUROCURRENCY DEPOSIT
See EUROCURRENCY DEPOSIT.

EURODOLLAR DEPOSIT
Dollar deposit claims upon United States Banks deposited in banks located outside the U.S., including foreign branches of U.S. banks, so that the funds do not physically leave the U.S. banks. These dollar deposit claims in turn may be re-deposited in other foreign banks, lent to business...
enterprises, invested, or retained to improve reserves or overall liquidity, reflecting the acceptability of dollars as a key reserve currency. The Eurodollar market is principally maintained by commercial banks in London, Paris and other European cities that are willing to accept such U.S. deposit claims as time deposits or CD’s in negotiable form. Such deposits may also be transacted in other currencies.

**FACTORIZING**
Sale of receivables to another company, who then has the responsibility to collect it.

**FDIC**
See FEDERAL DEPOSIT INSURANCE CORPORATION.

**FEDERAL CHARTER SAVINGS AND LOAN**
A savings and loan association chartered by the Federal Home Loan Bank Board (FHLBB). The 1989 Financial Institution Reform Recovery and Enforcement Act (FIRREA) eliminated the FLBB and replaced it with the Office of Thrift Supervision.

**FEDERAL DEPOSIT INSURANCE CO. (FDIC)**
The primary regulatory authority for FDIC insured banks or financial corporations. It was created in the 1930's to promote safe and sound banking practices and to protect bank deposits through deposit insurance. The 1989 Financial Institution Reform Recovery and Enforcement Act (FIRREA) placed responsibility of saving and loan association deposit insurance in the Savings Association Insurance Fund (SAIF), which is an agency of FDIC.

**FEDERAL FUNDS PURCHASED AND FEDERAL FUNDS SOLD**
Federal funds transactions involve the transfer of reserve balances by Member Banks of the Federal Reserve System, through which banks with reserve deficits borrow (“buy”), reserves from those banks with surplus reserves. Since reserve deficits and surpluses are often brief, most member banks borrow or lend (“sell”) reserves for relatively short periods, usually overnight.

**FEDERAL HOME LOAN BANK BOARD**
FHLBB is the federal agency that charters Federal Savings & Loans. It provides administrative services, conducts examinations and provides supervision of Federal Savings and Loans as well as those State Chartered Savings and Loans that elect to be covered by FSLIC insurance. The 1989 Financial Institutions Reform Recovery and Enforcement Act (FIRREA) replaced the FHLBB with the Office of Thrift Supervision.

**FEDERAL HOME LOAN MORTGAGE CORPORATION (FREDDIE MAC)**
Established in 1970 to aid the sale of residential mortgages sponsored by the Veterans Administration, the Federal Housing Administration and non-government insured mortgages in the secondary market.
F.H.A. LOAN
A loan insured 100% by the Federal Housing Administration, made to families that may not be adequately served by the private market.

FEDERAL NATIONAL MORTGAGE ASSOCIATION (FNMA)
A government sponsored private corporation, which offers a secondary mortgage market for FHA and VA insured mortgages (commonly referred to as "Fanny Mae").

FEDERAL RESERVE DISTRICT
The region served by each of the 12 Federal Reserve Banks. California is in the 12th Federal Reserve District.

FEDERAL RESERVE SYSTEM
The central banking system of the U.S., created by Congress in 1913. The central banking system consists of 12 Federal Reserve Banks and their 25 branches, National Banks that are required to be stockholding members of the Federal Reserve Bank in their Federal Reserve District, state chartered banks that elected to become members of the system, and all the depositing institutions brought under the jurisdiction of the Board of Governors of the Federal Reserve System.

FEDERAL SAVINGS & LOAN INSURANCE CORPORATION (FSLIC)
The FSLIC was established in 1934 to insure savings accounts of insured Savings and Loan Associations. State Chartered Savings and Loan Associations may obtain insurance upon application and approval by the FSLIC. The FSLIC functions under the direction of the Federal Home Loan Bank Board. The Financial Institution Reform Recovery and Enforcement Act (FIRREA) eliminated the FSLIC and replaced it with the Savings Association Insurance Fund (SAIF).

FEES
Charges made to bank customers for products or services. For example, monthly checking fees or annual fees for use of credit cards.

FIDUCIARY SERVICES
Services as a guardian, trustee, executor, administrator, or conservator for any other person.

FINANCIAL CORPORATION
A corporation that deals in moneyed capital as distinguished from other commodities and is in substantial competition with national banks.

FINANCIAL OFFSET
A credit allowed to financial corporations for certain taxes and licenses to the extent of the general corporation rate to equalize the tax burden between financial corporation corporations and banks.
Phased out for years ending after 12/31/80.

**FINANCIAL LEASE**
A lease that commits the lessee to payments that, in total, equal or exceed the purchase price of the property leased. Under this type of agreement, where the lease period is significantly less than the life of the asset, the lessee frequently has (and exercises) the option of acquiring title to the property for a nominal consideration at the end of the lease period. So the financial corporation lease is in substance the financing of a purchase (also known as a safe harbor lease, leverage lease or capital lease).

**FLOAT**
Time between presentation of a negotiable instrument such as a check and the actual collection of the funds.

**FLOOR**
Terms of a loan that state the minimum interest rate the customer will be charged.

**FNMA**
See FEDERAL NATIONAL MORTGAGE ASSOCIATION.

**FORECLOSURE**
The act of obtaining property that secures a defaulted loan.

**FOREIGN BANK AGENCY**
An office of a foreign bank located in the United States. Generally, it has full banking powers except that it cannot accept deposits from U.S. citizens or residents.

**FORWARD CONTRACT**
An agreement between the customer and the bank to deliver at a specified future date a certain amount of one currency for a certain amount of another currency at an agreed exchange rate.

**FRANC**
The monetary unit of Belgium, Benin, Burundi, Cameroons, Central African Empire, Chad, Comoros, Congo, Dahomey, Djibouti, France, French Somaliland, Gabon, Guadeloupe, Ivory Coast, Liechtenstein, Luxembourg, Madagascar, Monaco, New Caledonia, New Hebrides Islands, Niger, Oceania, Reunion Island, Rwanda, Senegal, Switzerland, Tahiti, Togo, and Upper Volta.

**FSLIC**
See FEDERAL SAVINGS & LOAN INSURANCE CORPORATION.
FUTURES
A contract to buy or sell a commodity at a specific time and value on a future date.

GNMA
See GOVERNMENT NATIONAL MORTGAGE ASSOCIATION.

GOODWILL:
One of a group of intangible assets set up on the balance sheet. It can be defined as the money value
of the reputation of a business or the premium set upon a going concern in excess of the book value
of the assets.

The capitalized cost of goodwill and most other intangibles acquired after August 10, 1993, and used
in a trade or business or for the production of income are ratably amortized over a 15-year period
beginning in the month of acquisition (IRC Section 197).

See Bank & Financial Handbook Section 0428, CORE DEPOSITS, for a discussion of core deposits.

GOVERNMENT NATIONAL MORTGAGE ASSOCIATION (GNMA)
A government corporation instrumentality of the Department of Housing and Urban Development
(HUD), whose purpose is to provide special assistance in financing of eligible types of federal
underwritten mortgages as well as other activities.

GUARANTEED STUDENT LOANS
Government loans to students that are processed and collected by banks.

GUILDER
The monetary unit of the Netherlands, Netherlands Antilles, and Surinam.

HEDGE
Similar to insurance, it is a transaction to protect one from possible future losses from changes in
prices, exchange or interest rates.

HARD CURRENCY
Currency whose value is expected to remain stable and is easily convertible to another currency.

HYPOTHETICAL RESERVE
A reserve based on the six-year moving average experience ratio used in the tax preference
computation to establish the taxpayer's actual loss experience.
INDUSTRY WIDE RATIO
Average loss ratio in the taxpayer's industry (financial corporations and banks). For California banks, the loan loss experience as published by FDIC.

INSURED LOANS
Loans that are guaranteed in part or whole against loss, typically VA or FHA loans.

INTANGIBLE PERSONAL PROPERTY
Assets such as loans, credit card receivables, investments in securities, etc.

INTEREST
An amount paid for the use or forbearance of money.

INTERNATIONAL BANKING FACILITY (IBF)
A facility represented by a set of asset and liability accounts segregated on the books and records of a commercial bank, the principal office of which is located in this state, and is incorporated and doing business under the laws of the United States or this state.

INVESTMENT BANKING
An entity which underwrites capital restructuring, such as initial public offerings, new issues, mergers, acquisitions and leveraged buyouts.

JUMBO CD’s
Certificates of deposit in denominations of at least $100,000.

KRONA
The monetary unit of Iceland and Sweden.

KRONE
The monetary unit of Denmark and Norway.

LEGAL DOMICILE
The jurisdiction of incorporation or organization as a bank.

LETTERS OF CREDIT
A guarantee by a bank to honor a borrowing by its customer from a third party, which states the customer has reserved on deposit with the bank sufficient funds to cover the borrowing.

LEU
The monetary unit of Romania.
LEV
The monetary unit of Bulgaria.

LIBOR
(London Interbank Offered Rate.) The rate at which banks in London place Eurodollars (Eurocurrency) with each other.

LINE OF CREDIT
The maximum amount a bank will loan a customer.

LOAN BASE
The average amount of eligible loans over a prescribed period used in computing the bad debt deduction under the reserve method.

LOAN FEE
A loan fee, also known as points or loan origination fee, is a charge to the borrower for making a loan, with the character of interest. For example, points are usually charged on home mortgages. Points are stated as a percent of the loan, i.e., one point equals 1% times the amount borrowed.

LOAN LIQUIDATION METHOD
A method of ratably reporting fee income over the life of a discounted loan. See also RULE OF 78 AND PRO-RATA BASIS METHODS.

LOAN LOSS RATIO
The average of the loss ratios used in the reserve method or the sum of the total losses for the period specified by the reserve method divided by the sum of the total uninsured outstanding loans for the period specified by the reserve method.

LOAN ORIGINATION FEE
See LOAN FEE.

LOAN PARTICIPATION
A joint loan by more than one bank or financial corporation to a common borrower.

LOAN PORTFOLIO
This term can represent the loans owned by a bank or financial corporation or a group of loans owned by a bank or financial corporation.

LOAN SWAP
See LOSS ON RECIPROCAL LOAN SALES.
LOCKBOX
A cash management system. Basically, a bank will provide a post office box to a customer. The letters in the post office box are opened daily and checks are deposited in an account. Typically, the ending daily account balance is transferred to the bank account of the parent corporation. The purpose of the lockbox system is to reduce the float time from processing customers' checks.

LOSS ON RECIPROCAL LOAN SALES
The concurrent sale and purchase of similar loans or loan portfolios between banks or financial corporations resulting in claimed losses by banks or financial corporations.

MERCHANT DISCOUNT
The percentage charged by the merchant's bank to the merchant to process and accept a credit card or debit card.

MONEYED CAPITAL
Moneyed capital is generally considered to be cash or its equivalent.

MONEY CENTER BANK
A term of art to describe the largest banks in the country which are head-quartered at major metropolitan areas such as Chicago, Los Angeles and New York City.

MONEY ORDER
A substitute for personal checks. This is a financial instrument purchased through a bank that is only payable to the person or company shown on the money order.

MORTGAGE
A security device by which the mortgagee (usually a bank or financial corporation) advances credit or funds to the mortgagor and takes a security interest in the mortgaged property to secure payment of the debt. The mortgagor may also be personally liable on the debt depending on the terms of the mortgage and the local laws.

MORTGAGE BACKED SECURITIES
Securities received by a bank or financial corporation from FNMA in exchange for a pool of mortgages.

MORTGAGE POOL
A group of individual mortgages packaged as a single unit for trading with (or sale to) other bank or financial corporations or for other activities such as exchanges with FNMA for mortgage backed securities.
MOVING AVERAGE
An average of the loss ratios of the current year and a specified number of the prior years (the number of prior years depends upon the code sections effective for the current year).

MULTIPLIER
A specified number (depending on the code section effective for the current year) multiplied times the product of the moving average ratio and the eligible loans outstanding for the current year, which is used to determine the maximum allowable reserve (reserve ceiling).

MUTUAL SAVINGS BANK
A banking institution organized especially to encourage thrift among persons of modest means by paying interest/dividends on savings deposits. There are no mutual savings banks in California.

MUTUAL SAVINGS & LOAN ASSOCIATION
A mutual savings & loan association offers savings accounts and makes loans, but has no capital stock. Its members are its depositors and borrowers. Periodically its net earnings and any surplus are to be distributed to its savings account holders pro rata to the amounts on deposit. Its net assets would similarly be distributed if liquidation or dissolution should occur.

NATIONAL BANK
A bank chartered by the Comptroller of Currency under the National Bank Act.

NEGOTIATED ORDER OF WITHDRAWAL (NOW)
An interest bearing transaction account; for example, a checking account that pays interest.

NET CHARGE-OFF
Realized losses on loans less recoveries on loans previously written off or written down.

NON-BANK
Deregulation in the banking industry has narrowed the gap between many types of financial institutions. Specific definitions are becoming unclear and a bank is no longer unique based upon products or services (for example there are thrifts that offer commercial credit services and brokerage firms that offer checking accounts). A non-bank can be illustrated by a financial facility that has some, but not all of the attributes of a bank, and therefore has not been granted the status of a "bank" by the state authorities. For example, the institution might lend money but not take in deposits or might take in deposits but not lend money.

NON-INTEREST BEARING LOAN
See ADD-ON INTEREST.

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ODD DAYS INTEREST
Escrow interest (also known as odd days interest, loans in process, deferred interest or interim interest) is the interest earned between the date escrow closes (date of sale) and the start of the period covered by the first mortgage payment. In most instances this is a very short period of less than 30 days, and this interest is included as a charge to the borrower on the escrow statement.

OFFICE OF THRIFT SUPERVISION
Created by the 1989 Financial Institutions Reform Recovery and Enforcement Act (FIRREA) to supervise the savings & loan industry. The Office of Thrift Supervision replaced the Federal Home Loan Bank Board (FHLBB).

OPERATING LEASE
A lease which is cancelable or that terminates before the lease payments have repaid the purchase price of the asset. A lease whereby the interest of the lessor is to earn money from the leasing of the property, not from the sale of the property.

ORE
See OWNED REAL ESTATE.

ORIGINAL ISSUE DISCOUNT (O.I.D.)
The excess of the stated redemption price of a debt instrument at the maturity date over the price paid for the instrument by the holder. (See IRC Section 1273.)

ORIGINATION FEES
See LOAN FEES.

OUT CLAUSE
An amount of provision to the bad debt reserve that is necessary to absorb current anticipated losses in the light of prevailing conditions relating to the taxpayer’s portfolio. This is commonly used by taxpayers to claim a larger provision than would be allowed under the experience method.

OWNED REAL ESTATE (ORE)
The name typically given by banks to represent property foreclosed on by the bank. See also REO.

PARKING
Assignment of a loan or other intangible by the taxpayer to a particular location, often where the taxpayer is not taxable.

PARTICIPATION CERTIFICATES (PC)
A certificate or note evidencing ownership by the holder, of a stated percentage of a "package" or "pool" of mortgages which pays interest at a stated rate.
PC
See PARTICIPATION CERTIFICATES.

PESETA
The monetary unit of Andorra, Canary Islands and Spain.

PESO
The monetary unit of Argentina, Chile, Columbia, Cuba, Dominican Republic, Mexico, Republic of the Philippines and Uruguay.

PEOPLES FORMULA
The method used to compute the bad debt reserve after a merger of two banks or financial corporations.

PERCENTAGE METHOD
A method (allowable for federal purposes only) used to determine the bad debt provision.

PERSONAL PROPERTY TAXES
Ad valorem tax on personal property that is eligible for financial corporation offset.

POINT-OF-SALE TERMINAL
Electronic terminals located at businesses so that customers can pay for goods and services by direct debits to their bank accounts. For example, some grocery stores and gasoline stations are equipped with terminals that allow the customer to use their ATM card to pay for goods.

POINTS
See LOAN FEE.

POUND (STERLING)
The monetary unit of Great Britain.

PRIMARY DEALER
A market maker for federal obligations. The dealer purchases U.S. government obligations from the Federal Reserve for resale.

PRIMARY RESERVE
The primary reserve is the premium account in the FSLIC to which all member institutions must pay their deposit insurance premiums. The basic premium is equal to 1/12 of 1% of its savings accounts. The FSLIC may also levy additional premiums to the full amount of its losses and expenses. The
1989 Financial Institution Reform Recovery and Enforcement Act (FIRREA) eliminated the FSLIC and created the Savings Association Insurance Fund (SAIF).

PRIME RATE
Generally, the rate banks charge their most credit-worthy customers.

PRODUCTION CREDIT CORPORATION
Established by the federal government to provide capital for production credit associations, which are local cooperatives of farmers and stockmen.

PRO-RATA BASIS METHOD
The pro-rata basis method is an accounting method generally used for determining the amount of discount to be recognized during the year for interest-bearing loans and mortgages. The ratio of the discount to the principal amount of the loan is applied to each principal payment to arrive at the reportable discount.

PROVISION
Amount deducted in the return based upon the bad debt reserve computation.

PURCHASED LOANS
Loans purchased from another bank or financial corporation.

QUALIFIED LOAN BASE
Known as the qualifying loan reserve (QLR). This represents loans at risk for federal purposes. Although similar to the eligible loan base it is not acceptable for California purposes. See also ELIGIBLE LOAN BASE.

REAL ESTATE OWNED (REO)
Name typically given by Savings & loans to represent property foreclosed on by the savings & loan. See also O.R.E.

REAL PROPERTY TAXES
Ad valorem taxes on real property and improvements not eligible for the financial corporation offset.

RECIPROCAL LOAN
See LOSS ON RECIPROCAL LOAN SALES.

REO
See REAL ESTATE OWNED.
REPRESENTATIVE OFFICE
An office of a bank located in a jurisdiction in which the bank is not qualified to carry on "banking activity". It has very limited powers in that it can only engage in representational functions. It cannot transact commercial banking business. Representatives are not employees of the bank, they have no authority to make or approve loans, however they may solicit loans.

REPURCHASE AGREEMENT
Customers deposit funds for a specific period of time. The bank sells the customers securities and buys them back at a later time. This transaction is basically a short-term loan to the bank.

RESERVE RATIO
The percent of coin and currency in the bank vault and deposits with the Fed to total assets.

RESERVE REQUIREMENT
The dollar amount required by the Federal Reserve to be held in reserve.

RESOLUTION TRUST CORPORATION (RTC)
Created by the 1989 Financial Institutions Reform Recovery and Enforcement Act (FIRREA) to hold and liquidate assets of failed thrifts.

REVALUATION OF SECURITIES
The write down of securities to market value while still retaining ownership of the securities. This book method of accounting is not allowable for California taxation purposes.

RESERVE CEILING
The maximum reserve allowable determined through the use of a multiplier.

RESERVE METHOD
A method used to deduct a reasonable amount of bad debt deduction based upon such indices as prior loss experience and/or industry-wide experience.

RULE OF 78'S METHOD
The Rule of 78's method, also known as the "money in use method" is the method of pro-rating the discount on non-interest bearing loans over a five-year period (generally the maximum term of such installment loans). It is a sum-of-the-years-digits method, i.e. the sum of the year's digits for a 12-month loan is 78. The first payment include 12/78th's of the total of the discount income, the second 11/78th's, etc. The total of the numerators of the fractions (12+11+10+9 etc.) equal 78, hence the name Rule of 78's.

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SALE OF FUTURE INTEREST
The stripping of a portion of the interest due from mortgage loans and sale to a bank. This can also be done with interest from CD's or PC's.

SALES TAX
A tax paid on the purchase of tangible personal property within the state. It is not eligible for financial corporation offset.

SAVINGS ASSOCIATION INSURANCE FUND (SAIF)
Replaced the FSLIC in 1989 as the insurer of the deposits of thrifts.

SAVINGS & LOAN ASSOCIATION
A financial corporation chartered by either the federal government through the Federal Home Loan Bank Board or through state charter. They were originally created to make home loans, however now the activities in which they may engage have been expanded substantially.

SECONDARY RESERVE
The secondary reserve was established in 1962 to require all FSLIC members to prepay their regular insurance premiums into the "Secondary Reserve of the FSLIC" for the purpose of providing a rapid buildup in the reserve balances. In 1974 Congress enacted legislation providing for the gradual phase-out of the secondary reserve. The phase-out is handled through yearly transfers from the secondary reserve to the primary reserve, with each member receiving an appropriate reduction in its yearly primary reserve premium liability.

SETTLEMENT CHARGES
Known as escrow charges, settlement charges are those fees and costs to be paid by the borrower and the seller at the close of escrow.

Such fees and costs would include but are not limited to the following:

- Broker's commissions
- Loan fees
- Credit reports
- Escrow interest
- Property taxes
- Title insurance
- Title search
- Recording fees and transfer charges

SHEKEL
The official currency of Israel.
SHELL BRANCH
An office having no physical assets or employees. Such offices are found in tax haven countries.

SMALL BUSINESS INVESTMENT COMPANY (SBIC)
A form of company designed to provide capital to small business. Licensed and regulated by the SBA as authorized by congress in 1958. The SBIC may make long-term loans or buy convertible debentures or stock in small enterprises.

SPECIFIC BAD DEBT METHOD
See SPECIFIC CHARGE-OFF.

SPECIFIC CHARGE-OFF
The deduction from income of debts determined to be worthless wholly or in part during the income year.

SPREAD
Difference between two numbers. For example, the bank annual report will disclose the interest rate spread that is the difference between the interest rate charged by the bank for a loan and the banks cost of funds expressed as a percent.

STATE CHARTERED SAVINGS AND LOAN
A savings & loan chartered by a state as opposed to one chartered by the Federal Home Loan Bank Board. It is subject to state regulation and if insured by the FDIC, it is also subject to regulation by that agency.

STATE SAVINGS & LOAN COMMISSIONER
The regulatory agency for state chartered savings & loans in California.

STOCK SAVINGS AND LOAN ASSOCIATION
A stock savings & loan is one in which the owners of the savings & loan, whether depositors or other persons, own capital stock which is transferable, but cannot be withdrawn (as would be in the case of a mutual savings & loan association). If it is a federally chartered institution, voting rights are also granted to depositors.

STRIPPED BOND
A stripped bond is the result of any transaction that strips the ownership of a bond, originally issued with interest coupons, from the ownership of any of the coupons not yet due or payable. (See IRC Section 1286.)
STRIPPED COUPON
Any coupon relating to a stripped bond. (See IRC Section 1286.) The term "coupon" means any right to receive future interest whether represented by a physical coupon or not.

SUBSTANTIAL COMPETITION
Competition is deemed to exist when activities are of the same type as conducted by national banks in the same general locality.

Competition is substantial if the corporation's predominant activity is in a general line of business that a national bank would engage in. (See CCR Section 23183.)

SUBSTITUTE EXPERIENCE
A loss experience used when the bank or financial corporation is newly formed and has insufficient loss history. See also INDUSTRY WIDE RATIO.

THRIFT INSTITUTION
A mutual savings bank, savings & loan association or a credit union.

TIME DEPOSIT
A deposit made with a bank or financial corporation, which is redeemable as of a specific point in time, 30 or more days after the deposit.

TRAVELERS CHECKS
A negotiable instrument sold by financial institutions in which the customers pay for goods and services by counter signing the check in the presence of the accepting party.

TRUST SERVICES
The fiduciary capacity in which a bank or financial corporation may act as executor, administrator, guardian or trustee.

UNEARNED DISCOUNT
In bank or financial corporations operating under the accrual system, the term unearned discount applies to interest which has been received in advance by deduction from the face value of the loan and is earned ratably as the note matures. For example, a 90-day note has been discounted for $6.00. After 30 days, the bank or financial corporation has earned $2.00 of the discount; the $4.00 remaining is the unearned discount.

UNINSURED LOANS
The loan balance at risk. Used in the computation of the loan loss ratio.
USE TAX
Tax to be paid on the purchase of tangible personal property that was purchased out of state, shipped from out of state and had title passage out of state. It is a tax eligible for financial corporation offset.

UTILITY USERS TAX
A tax assessed by a municipality on the taxpayer's use of water, gas, electricity, telephone, etc.

VA LOAN
A loan guaranteed 60% by the Veterans Administration.

WRITE DOWNS
The revaluation of foreclosed real estate downward upon proper appraisal.

WRITE DOWN OF SECURITIES
See REVALUATION OF SECURITIES.
0300 HOW TO START THE AUDIT

Bank & Financial Handbook Section 0305 – Introduction
Bank & Financial Handbook Section 0310 – Preliminary Examination of the Return
Bank & Financial Handbook Section 0315 – Record Available for the Audit
0305  INTRODUCTION

Banks and financial corporations are subject to certain special rules and regulations. Many of them are also subject to examination by regulatory agencies. There are many unique potential audit adjustment areas that the auditor should examine and investigate.
0310  PRELIMINARY EXAMINATION OF THE RETURN

As in every audit each auditor should prepare a meaningful audit program or pre-examination plan before contacting the taxpayer or practitioner. This plan constitutes a list of questionable items to check or areas to investigate based only on preliminary analysis and review of returns. The plan should be prepared with the idea that the plan may be changed as additional facts become available. The audit program should be realistic and flexible and identify any significant or unusual items that require further investigation.
0315 RECORDS AVAILABLE FOR THE AUDIT

- Annual reports and 10 Ks.
- Copy of the federal returns.
- Internal revenue audit reports.
- Minutes of meetings of boards and committees.
- Work papers reconciling annual report income to 1120 Schedule M-1, line 1.
- Form 100 work papers.
- Appropriate regulatory agency reports.
- General ledger, journals, and the chart of accounts.
- Receipts and invoices as required.

Depending on the circumstances, your audit may not require all of the above records. However, you should consider such records as annual reports or financial statements, copies of the federal returns and all work-papers used to prepare state and federal returns as essential elements to the conduct of a good audit.

The auditor should read and understand the footnotes to the annual report. The bank and financial industry has many book versus tax accounting differences that are reflected in the federal 1120, schedule M-1. An understanding of how the taxpayer reported an item for book purposes is required in order to determine if the tax treatment is correct.
0320  REGULATORY AGENCY REPORTS

The regulatory agency's report can be a very useful document, especially for unitary and bad debt audits. The report often details extensive unitary ties between the taxpayer and other related entities. The report may include detail regarding the taxpayer's bad debt provision.

The taxpayer may be reluctant to provide a copy of the examiner's report because the cover of the report states that the report is the property of the regulatory agency. That does not prevent the taxpayer from requesting permission from the regulatory agency to provide a copy of the report. Remember that the regulatory agency is concerned about the capital adequacy of the bank or thrift. Disallowance of deductions for lack of substantiation increases the bank or thrift's tax liability and decreases capital.

The auditor should remind the taxpayer that the information provided is confidential. The taxpayer or regulatory agency may not want to provide the portion of the report concerning the bad debt provision as the issue may come before the Board of Equalization. All evidence presented to the Board during an appeal is public. Such information may cause a run on deposits according to the taxpayer or the regulatory agency. The auditor should reply that the relevancy of the information to depositors at the time of any possible appeal is doubtful due to the amount of time between the year in question, the filing of the return, the audit and resolution of the protest.

Some taxpayers state that the regulatory agency report supports their tax position but they are prohibited from providing a copy of it, therefore the issue should be no changed. Such a statement should be treated as an unsubstantiated allegation.

Regulatory agency reports have been used before the Board of Equalization. See the Appeal of Center State Bank, April 7, 1987, which is an attempt by the taxpayer to use a highly critical FDIC report to justify a retroactive change to the bad debt deduction. In the Appeal of Sumitomo Bank of California, May 7, 1987 the FTB refers to various bank examiners' reports to substantiate unitary ties.

Another approach to obtain the information in the regulatory report is to ask the questions that would be in the standard examiner's report on one of our IDRs. Finally, we can issue subpoena duces tecum to the regulatory agency for their report. See your supervisor concerning the subpoena process.
0400 INCOME AND EXPENSE ISSUES COMMON FOR BOTH STATE AND FEDERAL PURPOSES

The issues addressed in the following discussion are applicable for both state and federal purposes. Accordingly, it is important to determine if any federal audits are currently being conducted on years covered by your audit or if a federal audit is scheduled. If this is the case, your audit should be restricted to state issues. Further, the audit file should contain information as to the expected completion date of the federal audit. Do not assume that because the taxpayer is a large case, a federal audit will necessarily be conducted. If the taxpayer can provide no information as to a pending or completed federal audit, you should include in your audit a review of income and expenses. Some of the issues addressed in this section may in certain instances result in only a shift of income within a year or between consecutive years and should only be pursued when the result will be cost effective.

The general theme of most of the subjects discussed in this section relates to the deferring of income or treatment of capital costs as current expenses. It is extremely important that a thorough review be made of all Schedule M adjustments. You should obtain detailed and complete explanations as to all adjustments, keeping foremost in your mind the effect of such adjustments. Also, are the adjustments consistent with the taxpayer's elected accounting method and are they consistent with elections approved for the taxpayer? As a rule, be wary of all income deferrals.
0402 TAX ACCOUNTING FOR BANKS AND FINANCIALS—IN GENERAL

Banks and financial corporations typically provide one of three descriptions for their method of accounting elected: CASH, ACCRUAL and HYBRID. Institutions describing their accounting method as cash are almost always in reality on a hybrid method. This is because while they generally account for their transactions on the cash basis, they use a reserve for bad debts to establish their bad debt provision. It is important to note that some of the following issues are directly affected by the accounting method elected.

Since the distinction between cash and accrual taxpayers is important, it deserves mention:

With respect to accrual method lenders:

"Income is included in gross income when all the events have incurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy."

With respect to cash basis lenders:

"All items which constitute gross income are to be included for the taxable year in which the income is actually or constructively received."
0404 ACCOUNTING PRINCIPLES

Bank & Financial Handbook Section 0404.1, DIFFERENCES BETWEEN GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP), REGULATORY ACCOUNTING PRINCIPLES (RAP), AND TAX ACCOUNTING.
0404.1 Differences Between Generally Accepted Accounting Principles (GAAP),
Regulatory Accounting Principles (RAP), And Tax Accounting

It is important to recognize the fact that there are differences in how income, expenses, assets, and liabilities are reflected in the various types of financial statements that will be encountered in your audits. For information on RAP accounting principles review the instruction booklets for the bank call reports entitled Federal Financial Institutions Examination Council "INSTRUCTIONS - CONSOLIDATED REPORTS OF CONDITION AND INCOME."
0406 ACCOUNTING METHODS FOR INCOME RECOGNITION

Many banks and financial corporations use different accounting methods of income recognition for book purposes, for regulatory agency purposes, and for tax purposes. Income may be under-stated by the improper deferral or omission of income. Auditors should familiarize themselves with the method of accounting for book purposes and for tax purposes. Some of the methods of recognizing interest and discount income are as follows:
0406.1 (1) Accounting Methods For Income Recognition—The General Rule

Interest income shall be recognized as income when received by cash-basis taxpayers and when earned by accrual basis taxpayers.

0406.2 (2) Accounting Methods For Income Recognition—Loans Or Mortgages Made Or Acquired At A Discount

Generally, the discount on both interest and non-interest bearing loans and mortgages is reportable as income when earned by a taxpayer on the accrual basis or when note payments are received by a taxpayer on the cash basis. The reporting of the discount may be deferred until the full loan is paid only under the following exceptional circumstances:

- Realizable discount is uncertain.
- Full collection of the loan appears doubtful.
- The loan contract has no ascertainable market value.

For a discussion of the treatment of the deferring of discount income, see Bank & Financial Handbook Section 0408, METHODS OF TREATMENT OF ORIGINAL ISSUE DISCOUNT (OID) and Bank & Financial Handbook Section 0406.3, THE LOAN LIQUIDATION METHOD FOR CASH BASIS TAXPAYERS.
0406.3 Accounting Methods For Income Recognition—The Loan Liquidation Method

Prior to the Internal Revenue Service's adoption of the principal-reduction method of accounting, required for income years that end on or after December 22, 1992 or beginning on or before April 4, 1994, most financial institutions used the loan liquidation method to account for "discounted interest." (See Bank & Financial Handbook Section 0406.4, PRINCIPAL REDUCTION METHOD.) The Internal Revenue Service approved the use of the loan liquidation method in Rev. Rul. 64-278 for cash basis taxpayers, and continued to allow taxpayers, including accrual basis taxpayers, to use the loan liquidation method of accounting until the adoption of the principal-reduction method of accounting. During 1966 the Franchise Tax Board directed staff to follow Rev. Rul. 64-278.

Under the "Liquidation Method" of accounting a bank or similar taxpayer determines the amount of interest received from a pool of loans made at a discount in the following manner. First, the percentage of loan principal liquidated each month is determined by dividing the amount of loan principal liquidated during each month by the total loan principal outstanding at the beginning of the month. Second, the percentage of liquidation is applied to the unearned interest applicable to such loans to determine the amount of interest being realized during the month.

Example:
At the beginning of the month Y had outstanding loans of $500,000 and unearned discount of $50,000. During the month, $100,000 of the loans that were outstanding at the beginning of the month was liquidated, making the percentage of liquidation 20%. This percentage applied to the unearned interest of $50,000 results in $10,000 of earned interest being realized during the month.

This method was allowed first by Rev. Rul. 64-278. In order to use this method a taxpayer must request a private letter ruling (PLR). The request will spell out which items in addition to interest are to be included in this computation. The taxpayers are not automatically guaranteed approval of their request. A number of problems have surfaced around the use of this method. The following addresses the major problems and minimum audit steps:

1. Always review the taxpayer's private letter ruling and the change of accounting request. The letter rulings differ from one taxpayer to the next in so far as what items are allowed to be included in the computation. The fees to include in the loan liquidation schedule are limited to those listed in the taxpayer's original change in accounting request and approval. Typically, the approval limits the included fees to financed points, although there were often letters of approval that allowed other fees to be included in the loan liquidation schedule.

Since the loan liquidation method is a method of income deferral, taxpayers may attempt to include a variety of current income items into the computation. If the private letter ruling does not expressly provide for the inclusion of the fee in question, then they will be excluded from the loan liquidation
The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.

2. Construction period interest is normally earned over a relatively short term (the amount of time a construction project will take to complete). It would be inappropriate to include such interest income in the loan liquidation computation, since the average life (about 8 years) of real estate loans is considerably longer. A more appropriate alternative would be to make a separate liquidation computation for construction loans. However, if a review of the taxpayer's private letter ruling letter authorizing the loan liquidation method discloses that construction period interest is included then no adjustment should be made.

If the auditor proposes to create a separate loan liquidation schedule for construction period interest, then the auditor needs to document the average life of the construction loan and the average life of the mortgages.

3. Credit card fees are payments received by an association for the privilege of using a credit card. These fees are current operating income and should not be included in the amortization schedule.

4. Participation fee income, also known as servicing income, arises from the service charges received from the servicing of the participation loan contracts. This is a current income item and should not be run through the loan liquidation schedule.

5. Sale of loan portfolio. When a taxpayer sells a loan portfolio, the unamortized loan fees must be accelerated into income.

The taxpayer may sell a portion of the loans originated during the current year. There is no theoretical reason to exclude the loan fees from income in the current year. The taxpayer may be of the opinion that from a practical view point, inclusion of the loans sold during the current year will increase the liquidation percent which is multiplied by a larger amount of loan fees which results in a wash. This may or may not be true depending on the factors included in the loan liquidation schedule.

6. Mergers (should separate loan liquidation schedules be used). See also Bank & Financial Handbook Section 0464, MERGER/LIQUIDATION TAX EFFECTS.

7. Loans should not be included in the liquidation schedule if the points or other fees are paid in cash. There is no reason to defer the fees paid in cash from income. It has been difficult to audit this issue because the loan documents are not clear as to which fees and portion of the loan are paid in cash and which are financed. Although the documents may be ambiguous, ambiguity by itself on this issue has not been sufficient to demonstrate fees were paid in cash, not financed, and were improperly included in the loan liquidation method of accounting.
Loans that have no points should not be included in the denominator used to compute the liquidation percentage.

0406.4 Accounting Methods For Income Recognition—Principal Reduction Method

On February 2, 1994, the IRS issued final regulations dealing with original issue discount and other related matters. On April 5, 1994, the IRS issued Rev. Proc. 94-28, 1994-1 C.B. 614; 94-29, 1994-1 C.B. 616; and 94-30, 1994-1 C.B. 621 to provide guidance for taxpayers to comply with the final OID regulations. In general, the revenue rulings require a change in method of accounting for financial institutions for income years ending on or after December 22, 1992 and beginning on or before April 4, 1994. Rev. Proc. 94-29 declared obsolete the following revenue rulings:

- Rev. Rul. 53-216 and Rev. Rul. 54-367, both discussing the composite method of accounting for discount.
- Rev. Rul. 64-278, discussing the liquidation method of accounting for discount.
- Rev. Rul. 70-540 and Rev. Rul. 74-607, discussing the treatment of points and the requirement that points be paid in cash for the taxpayer to use the loan liquidation method of accounting.

The principal-reduction method of accounting for discount is an aggregate method of accounting for de minimis OID for certain loans originated by the taxpayer. See IRC Section 1273(a)(3). The principal-reduction method is based on the rule that, if a taxpayer holds a debt instrument with de minimis original issue discount, the taxpayer must include that discount in income as stated principal payments are made. The term de minimis OID is defined as an amount equal to 0.0025 multiplied by the product of the stated redemption price at maturity and the number of complete years to maturity from the issue date. If the excess of the stated redemption price over the issue price is less than 1/4 of 1% of the stated redemption price times the number of years to maturity, then the OID is zero. See Treas. Reg. Section 1.1273-1(d).

For example:

First Thrift issues a $200,000 fifteen-year mortgage that includes funds for the home purchase of $194,000 and $6,000 of points. The stated redemption price is $200,000 and the issue price is $194,000, which results in possible OID of $6,000.

.25% times the stated redemption price of $200,000 equals $500. $500 times 15 years equals $7,500. The OID is de minimis since $6,000 is less than the calculated amount of $7,500.

Most mortgages on individual residences will likely come under the de minimis rule given industry practices. See Bank & Financial Handbook Section 0456, LOAN FEES, for additional discussion of de minimis OID in regards to financed points.

There are four standard categories of loans:
1. One to four-unit family residential real property that are not home equity lines of credit or construction loans.
2. Construction loans with terms less than three years.
3. Other loans secured by real property that are not home equity lines of credit.
4. Consumer loans with terms less than seven years, not secured by real property, and not revolving credit loans.

The formula, calculated on a monthly basis for each of the standard categories of loans, is as follows:

Discount (points) included in Income =

\[
\left[ \frac{\text{Starting Discount} + \text{Current Discount}}{\text{Starting Principal} + \text{Current Principal} - \text{Ending Principal}} \right] \times \frac{\text{Starting Principal} + \text{Current Principal} - \text{Ending Principal}}{\text{Starting principal} + \text{Current principal}}
\]

The amount of the loan is the same whether the cash is considered as paying loan fees and odd-days interest or whether the cash is decreasing the mortgage. A flow of funds analysis allows all loan fees to be included within the principle-reduction method of accounting. Commitment fees and service fees are included in income when they are earned or received, whichever is earlier.

Also see Bank & Financial Handbook Section 0456, LOAN FEES.
0408 METHODS OF TREATMENT OF ORIGINAL ISSUE DISCOUNT (OID)

IRC Sections 1271 through 1275 provide rules for the inclusion of OID. OID is the excess of the stated redemption price at maturity over the issue price. For example, assume ABC Inc. acquired a non-interest bond for $80,000 that was redeemable in 5 years for $100,000. The stated redemption price at maturity of $100,000 less the issue price of $80,000 results in $20,000 of OID.

IRC Section 1273(a)(3) provides for a de minimis rule. If the excess of the stated redemption price over the issue price is less than 1/4 of 1% of the stated redemption price times the number of years to maturity, then the OID is zero. See Bank & Financial Handbook Section 0406.4, PRINCIPAL REDUCTION METHOD.

The "Constant Interest Rate Basis Method" is generally used in computing the reportable discount on interest bearing loans, bonds and mortgages issued under an OID.

See also Bank & Financial Handbook Section 0548.4, ORIGINAL ISSUE DISCOUNT.
0408.12 Summary Of The Proper Reporting Of Discount Income

A. Interest Bearing Loans

Discount under the cash basis method:

- Interest bearing loans purchased at a discount. The discount is income earned ratably as the obligation is collected. The interest is income as received.

- Interest bearing installment loans purchased at a discount. The balance of the installment payment after being reduced by the applicable portion of interest income is then ratably apportioned between discount income and a reduction of the cost basis.

Discount under the accrual method:

- Interest bearing loan purchased at a discount. The discount is income earned ratably as the obligation is collected. The interest is income as earned.

- Interest bearing installment loans are purchased at a discount. The interest is income as earned. The balance of the installment payment after being reduced by the applicable portion of interest income is then ratably apportioned between discount income and a reduction of the cost basis.

B. Non-Interest Bearing Loans

Discount under the cash basis method:

- Non-interest bearing loan made directly to the borrower. The discount and commissions are income earned when the loan is paid in full.

- Non-interest bearing installment loan made directly to borrower. The discount and commissions are income earned ratably as each installment is received.

- Non-interest bearing loan purchased at a discount from a third party. The discount is income earned when the note is paid in full. In the case of an installment loan, discount and commissions are income ratably as each installment is received.

Discount under the accrual method:
• Non-interest bearing loan made to borrower. The discount is income earned over the period of the loan. The commission is income when the loan is made. If the loan is subsequently extended, any additional commission charge is income when the loan is extended.

• Non-interest bearing loan purchased at a discount. The discount is income earned over the remaining period of the loan.
0408.2 Methods Of Treatment Of Original Issue Discount (OID)—Years Ending On Or After 1/1/87—Use IRC Section 1271

Effective for years beginning on or after 1/1/87, R&TC Section 24990 conformed to the treatment of OID to IRC Sections 1271 through 1288. IRC Sections 1271 through 1288 provide complex rules that require the current exclusion and deduction of discounts and treatment of gain on the sale or retirement of debt instruments. These depend on a number of factors. Among these factors to be considered are the types of debt instruments you hold, when they were issued, and whether the issuer had an intention to call the debt instrument before maturity. See IRC Sections 1271 through 1284 for specifics.
0408.21 Methods Of Treatment Of Original Issue Discount (OID)—Long Term Obligations Issued After 7/1/82 (IRC Section 1272(a))

The "Constant Interest Rate Basis Method"

The constant interest rate basis method requires recognition of OID based on the increase in the loan’s liquidation or carrying value during the taxable year. The statute (IRC Sections 1271 through 1284) sets forth the following computation for determining the amount of OID to be recognized:

1. Determine the loan’s rate of yield to maturity (as opposed to the stated interest rate) based on annual compounding:

2. Multiply the loan’s “adjusted issue price” at the beginning of the accrual period by the yield to maturity. The accrual period is the 6-month period (or shorter period from the date of original issue) ending with the date in the calendar year that corresponds with the maturity date of the instrument of the date 6 months before such date. The “adjusted issue price” of a loan as of the beginning of any loan period is its original issue price plus all OID attributable to prior loan periods;

3. From the amount determined in (2), subtract the cash interest paid by the issuer during the loan period to determine the OID attributable to that loan period;

4. Divide the OID amount determined in (3) by 365 to determine the pro rata “daily portion” of OID (as defined in IRC Section 1272) for the loan. The amount of OID included in the income of the bank or financial for any taxable year is the daily portion, determined as described above, multiplied by the number of days of the relevant loan period contained in the taxpayer's taxable year during which the loan was held.

Example: Taxpayer A makes a 10-year loan having a face value amount of $15,000 and a stated interest rate of 10% as part of an original issue on 9/1/87 for $13,500. The OID on the loan is $1,500 (15,000-13,500). Under prior law (the pro rata basis method), the discount would be taken into the income of the holder ratably over the term of the loan (i.e. $15,000/10 years = $150 per year; income from OID in 1987 would be $150 x 4/12 = $50).

The new computation would be as follows:

The first step is to calculate the “yield to maturity” of the loan. This calculation has two separate elements; the yield received on the principal, and the yield of the interest payments made over the term of the loan. There is no simple method to determine the yield because the yield to maturity must be identical for both elements. In the example below note that the calculated discount rate (yield) for both
elements is 11.7%. This is a situation in which you know the value of the loan and you must determine what the two amounts are that make up that value. Since we know that the value of the loan is $13,500 (its original cost), we must determine the common yield value, which when applied to each element will give a total value of $13,500.

If a bond yield table is available, the yield can be determined in 1 step by first determining the price % of the instrument. In this case the loan is selling at 90% (13,500/15,000 = 90%), and then using the other known factor, the term of the loan (in this case 10 years), find the yield rate in the tables.

As can be seen from the above, the best method is to have the taxpayer show how the calculations have been made and then simply review them for accuracy.

(1) Calculate yield to maturity—

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan principal</td>
<td>$15,000</td>
</tr>
<tr>
<td>Stated interest rate</td>
<td>10%</td>
</tr>
<tr>
<td>Annual cash interest</td>
<td>1,500</td>
</tr>
<tr>
<td>Present value of $15,000 due at retirement discounted at 11.7%</td>
<td>$4,965 (a)</td>
</tr>
<tr>
<td>Present value of 10 annual payments of $1,500 discounted at 11.7%</td>
<td>$13,551</td>
</tr>
</tbody>
</table>

Loan yield to maturity approximately equals 11.7%. To derive the yield, one of the three methods must be used:

a) Use a combination of the present value of $1 (a) and the present value of an annuity of $1 (b) to “back into the yield rate” or

b) Use bond yield tables such as “Barrons Financial Tables”.

c) Have the taxpayer provide the calculations. The goal is to find the appropriate yield rate, which when applied to both the principal and the interest will equal the cost of the loan.

(2) “Adjusted issue price” (first loan period):

$13,500 (adjusted issue price) x 11.7% (yield to maturity) = $1,580 (income attributable to loan period)

(3) Annual cash interest: $15,000 x 10% = $1,500
$1,580 (income attributable to loan period) - $1,500 (cash interest paid) = $80 (OID allocable to bond period)

(4) “Daily portion” = $80/365 = $.22

OID recognized in 1987 = $.22 x 122 days (days of the loan period included in the taxpayer's 1987 taxable year during which he held the bond) = $26.84.
0410 CHANGE OF ACCOUNTING METHOD

The consent of the IRS or Franchise Tax Board is required before a taxpayer changes its method of accounting for tax purposes. Rev. Rul. 64-278 held that permission would be granted to a bank, using the cash receipts/disbursements method of accounting, to change to the "liquidation method" of reporting interest on loans made at discount. The liquidation method was a composite method that had the effect of apportioning the interest income on the loans over the terms of such loans on a straight-line basis. See also Bank & Financial Handbook Section 0406.3, THE LOAN LIQUIDATION METHOD FOR CASH BASIS TAXPAYERS.

Rev. Proc. 94-29 allows a taxpayer to use the principal-reduction method of accounting, precludes use of the loan liquidation method of accounting for loans acquired after a certain date, and grants consent for a taxpayer to use the principal-reduction method of accounting. See also Bank & Financial Handbook Section 0406.4, PRINCIPAL REDUCTION METHOD.

Rev. Proc. 94-30, 1994-1 C.B. 621, provides transition rules for taxpayers, for loans acquired before the applicable cut-off dates described in Rev. Proc. 94-29, and prescribes the only methods of accounting to which taxpayers may change for these loans.
0412  ACCRUED INTEREST TO DATE OF FORECLOSURE

This section is provided for historical reference only. CCR Section 24348(b) is repealed and is not applicable for taxable years beginning on or after January 1, 2002. The use of the reserve method of accounting for bad debts by banks and savings & loans is severely limited by IRC Section 585 to "small banks" as defined in IRC Section 585(c). Financials are no longer allowed to use the reserve method of accounting for bad debts. For an explanation of the current rules regarding the deduction for bad debts for banks and savings & loans, see Bank & Financial Handbook Section 0504, PROVISION FOR BAD DEBTS—FEDERAL AND CALIFORNIA METHOD.

The issue of accrual of interest in connection with troubled loans has several different facets that must be considered. It is important to remember that the handling of foreclosed property in relation to the bad debt deduction is different for savings & loan associations as compared to banks and financials. R&TC Section 24348.5 (IRC Section 595) applies only to savings & loan associations and requires that no gain or loss be recognized at the time of foreclosure. When the foreclosed property is sold, gain or loss on the sale of the property is debited or credited to the reserve.

All other taxpayers (including banks and financials) must recognize gain or loss at foreclosure (R&TC Section 24952; IRC Section 1038)). At issue is the treatment of interest income earned but not received in connection with troubled loans. When a bank, savings & loan, or financial has a loan on which payments are no longer being made, it must decide how to treat the interest income it is not receiving but has earned. The issue is important for tax purposes since interest income does not flow through the bad debt computation, but directly to the income statement. If the interest income were to flow through the bad debt deduction, it might not have a current tax effect (it would only decrease the reserve balance). Taxpayers have attempted several methods in washing the interest income through the reserve. See also Bank & Financial Handbook Section 0450, INTEREST INCOME-ACCRUAL FOR TROUBLED LOANS.

The Tax Reform Act of 1986 denied the use of the reserve method for bad debts for large banks and financial corporations. The issue of accrued interest to date of foreclosure would not be relevant for these entities for federal purposes but may for state purposes. Large banks are defined as those with more than $500 million of assets. Small banks may still use the reserve for bad debts for federal purposes.
0412.1 Small Banks Using The Accrual Method

This section is provided for historical reference only. CCR Section 24348(b) is repealed and is not applicable for taxable years beginning on or after January 1, 2002. The use of the reserve method of accounting for bad debts by banks and savings & loans is severely limited by IRC Section 585 to "small banks" as defined in IRC Section 585(c). Financials are no longer allowed to use the reserve method of accounting for bad debts. For an explanation of the current rules regarding the deduction for bad debts for banks and savings & loans, see Bank & Financial Handbook Section 0504, PROVISION FOR BAD DEBTS—FEDERAL AND CALIFORNIA METHOD.

At foreclosure, small banks are required to charge losses to the reserve and include gains in income. Consequently, the issue of where the interest income should be reported is moot. If there is a gain at foreclosure, the gain is included in income (the assumption is that the gain is attributable at least in part to the interest income). The IRS is pursuing a related issue dealing with banks on the accrual basis that fail to accrue interest on delinquent loans placed in a non-accrual status. Briefly, this involves banks that fail to accrue interest on loans that are delinquent, but have not been written off. The IRS cites IRC Section 451(a); Treas. Reg. Section 1.451(a); IRC Section 166(a) and Rev. Rul. 80-361. The IRS position is that interest must be accrued unless on a loan-by-loan basis the circumstances fit the following:

- If the bank, bank examiner, or regulatory agency has given written specific instructions that a loan, in whole or in part, should be charged off as a bad debt, then on the account so charged no further interest should be accrued. Interest should continue to be accrued up until the date the account is charged off. Previously accrued but uncollected interest relating to the amount written off should be charged to the reserve account.

- On loans not charged off, the taxpayer must, on a loan-by-loan basis, substantiate that the interest is not collectible in accord with Rev. Rul. 80-361.

It is the taxpayer's responsibility to present to the auditor a schedule showing the detailed specifics of how the non-accrued interest was determined. Usually the annual report will contain just a summary figure of the amount. It is only by working with a detailed schedule that we will be able to do a proper audit of this area. Caution—this is a timing adjustment, i.e., an increase to income in earlier years will result in a decrease to income in later years. Overall tax materiality should be given consideration.
0412.2 Banks And Financials Under The Cash Method

This section is provided for historical reference only. CCR Section 24348(b) is repealed and is not applicable for taxable years beginning on or after January 1, 2002. The use of the reserve method of accounting for bad debts by banks and savings & loans is severely limited by IRC Section 585 to “small banks” as defined in IRC Section 585(c). Financials are no longer allowed to use the reserve method of accounting for bad debts. For an explanation of the current rules regarding the deduction for bad debts for banks and savings & loans, see Bank & Financial Handbook Section 0504, PROVISION FOR BAD DEBTS—FEDERAL AND CALIFORNIA METHOD.

Delinquent interest is not an issue for these taxpayers because:

- Gains on foreclosure are reported as income.
- Since the taxpayer reports interest income as it is received, the failure to accrue interest does not arise.
0412.3 Savings & Loan Associations Under The Cash Method

This section is provided for historical reference only. CCR Section 24348(b) is repealed and is not applicable for taxable years beginning on or after January 1, 2002. The use of the reserve method of accounting for bad debts by banks and savings & loans is severely limited by IRC Section 585 to "small banks" as defined in IRC Section 585(c). Financials are no longer allowed to use the reserve method of accounting for bad debts. For an explanation of the current rules regarding the deduction for bad debts for banks and savings & loans, see Bank & Financial Handbook Section 0504, PROVISION FOR BAD DEBTS—FEDERAL AND CALIFORNIA METHOD.

S&Ls are required to recognize gain or loss only upon disposition of the foreclosed real estate owned. Often S&Ls will credit the gain to the reserve without taking into consideration delinquent interest. Rev. Rul. 75-251 provides that delinquent interest income to the extent of the gain must not be credited to the reserve, but must be reported as income. The cases of Gibraltar Financial Corporation of California v. United States, (Fed. Cir. 1983) 825 F.2d 1568 and First Charter Financial Corporation v. United States (9th Cir. 1982) 669 F. 2d 1342 validated this revenue ruling. If no gain results from the sale of the REO, no delinquent interest income shall be recognized. Example:

A cash basis S&L foreclosed on a real estate loan of $20,000. There was delinquent interest income of $600 on the loan up to the date of foreclosure. Later the association sold the foreclosed real estate for $30,000, resulting in a $10,000 gain being realized. The delinquent interest of $600 will be recognized as income and the remaining $9,400 gain will be credited to the reserve.

Have the taxpayer provide you with the records providing the detail on the sales of foreclosed property and inquire as to how delinquent interest is handled.
0412.4 Savings & Loan Associations Under The Accrual Method

This section is provided for historical reference only. CCR Section 24348(b) is repealed and is not applicable for taxable years beginning on or after January 1, 2002. The use of the reserve method of accounting for bad debts by banks and savings & loans is severely limited by IRC Section 585 to "small banks" as defined in IRC Section 585(c). Financials are no longer allowed to use the reserve method of accounting for bad debts. For an explanation of the current rules regarding the deduction for bad debts for banks and savings & loans, see Bank & Financial Handbook Section 0504, PROVISION FOR BAD DEBTS—FEDERAL AND CALIFORNIA METHOD.

If an S&L has properly accrued the delinquent interest income on loans, there will be no issue since the income has been reported. If however, there has been a failure to accrue the interest by the taxpayer, an appropriate adjustment can be made to require the accrual. Caution: this adjustment may result in only a timing adjustment, i.e., an increase in tax in earlier years will result in a decrease in tax at the time of sale of the REO if the delinquent interest was picked up at that time.
0414 ALTERNATIVE MORTGAGE INSTRUMENTS

The conventional mortgage is characterized by fixed payments, set interest rates, and long maturities. Due to volatile interest rates in the late 1970's and early 1980's banks and thrifts wanted to shift some of the risk to the customer. Alternative mortgage instruments (AMI's) offer possible relief from liquidity problems by providing yields that are comparable to current rates paid on deposits.

AMI's do not have one or more of the characteristics listed above for a conventional mortgage. The most common types of AMI's are the:

- **Variable rate mortgage (VRM)**—Characterized by an interest rate that will fluctuate based on the terms of the loan agreement. The rate is linked to a specific index, and the payments are periodically adjusted upward or downward. This can result in a larger or smaller monthly mortgage payment or a longer or shorter length of time to pay off the mortgage.

- **Graduated payment mortgage (GPM)**—Intended to allow prospective home buyers who anticipate increasing incomes, to acquire mortgages which more clearly reflect their ability to pay. For example, a new accounting graduate may be hired by the FTB. After one year he or she will hopefully be promoted and will most likely receive step increases for the next four years. The mortgage agreement may provide for a lower payment in year one. The monthly payment will increase each year for 5 years, and will then have level payments for 25 years.

The VRM and the GPM may result in negative amortization. That is the monthly payment is not enough to cover the total interest, thus the unpaid interest is added to the principal. In the above example of a GPM, negative amortization would result in the first five years.

Since a greater portion of loans are written for the purchase of real property, the savings & loan industry was one of the leaders in AMI's.

On February 6, 1975 the Federal Home Loan Bank Board issued regulations authorizing AMI's. Criticism by Congress resulted in the Board not pursuing the regulations. In 1978, the Bank Board authorized AMI's by allowing variable rate mortgages to some degree. The regulations were amended in 1980.

On April 23, 1981 the FHLBB issued new regulations providing broad authority of federal chartered savings & loan associations to deal in a variety of adjustable mortgage loan instruments. The regulation also preempted all state laws concerning loan instruments on federal chartered savings & loan associations and mutual banks thus establishing a uniform national standard.
On March 27, 1981 the Office of Comptroller of the Currency issued rules governing the authority of national banks to make or purchase adjustable rate mortgage (ARM) loans. The rules were similar to the FHLBB regulations.

Liquidity is of great importance for all financial institutions. Many financial institutions sell mortgages in secondary markets to generate cash. Much of a financial institution’s income may come from loan fees and servicing the loan rather than collecting periodic interest payments.

The Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC) are two federal agencies that purchase home loans. Their guidelines are normally more restrictive than the FHLBB and the Comptroller of the Currency, which may result in financial institutions offering more restrictive AMI's.

The mortgage loan industry has developed a wide range of AMI's, although each loan is basically a variable rate mortgage or a graduated payment mortgage. The primary difference between AMI's and conventional loans is the manner, timing, and amount of interest and principal payments.

The tax treatment of the AMI is substantially the same as conventional loans with the following exceptions:

- The AMI may result in negative amortization; that is the payments are not large enough to cover all the interest due resulting in the unpaid interest being added to the principal.

Prior to the Tax Reform Act of 1984 a cash basis lender would not record the income until paid in cash. A cash basis borrower would not deduct the interest until paid in cash.

The Tax Reform Act of 1984 expanded application of the original issue discount (OID) rules to apply to home mortgages. The OID rules (IRC Section 1272; R&TC Sections 24990 through 24994) in regards to negative amortization may result in a cash basis lender recognizing income without receiving cash.

For additional information on OID, see Bank & Financial Handbook Section 0406, ACCOUNTING METHODS FOR INCOME RECOGNITION.

- The amortization of loan fees is more difficult as the length of the loan may change if the loan provides for negative amortization.

- If the interest rate fluctuates, the mortgage may result in prepaid or deferred interest. If the rate change is based on an objective standard such as the prime interest rate, then all interest should be included in current income. Also see Bank & Financial Handbook Section 0452, INTEREST RECEIVED IN EXCESS OF A MAXIMUM AMOUNT (CAP).
The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.
0416  BRANCH APPLICATION COSTS

Sections 6550-6553 of the Financial Code require an additional license for a branch facility. The Legislature has effectively characterized each branch as a separate enterprise with an unlimited useful life.

All expenses attributable to the acquisition of the branch office should be capitalized; for example, related executive salaries, feasibility studies, attorney fees, etc. The license costs are not amortizable as they have an unlimited life. The costs incurred for the branch application would be deductible if the application is denied.

The auditor should review the annual report or regulatory agency report, if provided, to determine the existence of any new branches. The taxpayer may have handbooks that have general information about the taxpayer, including a list of branches.

Once the auditor has established that the taxpayer has a new branch, the auditor should inquire about the amount of branch application costs to be capitalized. Accounting Principles Board (APB) opinion #17 provides that for book purposes, intangibles are capitalized and amortized over the period benefited, not to exceed 40 years. A review of the costs capitalized for book purposes and an inquiry of the types of expenses incurred in establishing the new branch may be a sufficient tax audit procedure, depending on how material the item is.

In Private Letter Ruling 8135031 the IRS ruled that a mutual savings bank could currently deduct promotional expenses such as advertising and gifts for new depositors involved in opening a new branch.

The Court in *NCNB Corp. v. U.S.*, (4th Cir. 1982) 684 F2d 285 held that expenditures for long-range planning reports, feasibility studies and applications to the Office of the Comptroller of the Currency were current year expenses.

The Fifth Circuit in *Central Texas Savings & Loan Association v. U.S.* (5th Cir. 1982) 731 F2d. 1181 held that costs incurred to investigate and establish new branches of a savings and loan association were not deductible under IRC Section 162(a). The expenses "procure benefits that endure for the life of the branch" and thus must be capitalized.

The Department follows the decision in *Central Texas Savings & Loan Association v. U.S.*, supra.

The Tax Reform Act of 1984 revised IRC Section 195 relating to start-up expenditures. Beginning after June 30, 1984, no deduction is allowed for start-up costs although the taxpayer may elect to amortize the costs over 60 months. R&TC Section 24414 has the same provisions (except for effective dates) as IRC Section 195.
The IRS has not issued regulations to date concerning IRC Section 195. There is some question if branch application costs will ultimately be classified as start-up expenditures.
0418  BAD DEBT RESERVE—RESTORATION TO INCOME

This section is provided for historical reference only. CCR Section 24348(b) is repealed and is not applicable for taxable years beginning on or after January 1, 2002. The use of the reserve method of accounting for bad debts by banks and savings & loans is severely limited by IRC Section 585 to "small banks" as defined in IRC Section 585(c). Financials are no longer allowed to use the reserve method of accounting for bad debts. For an explanation of the current rules regarding the deduction for bad debts for banks and savings & loans, see Bank & Financial Handbook Section 0504, PROVISION FOR BAD DEBTS—FEDERAL AND CALIFORNIA METHOD.

CCR Section 24348(c) provides that when all reason for maintaining a reserve ceases, the reserve balance must be recaptured to income. The regulation defines "all reason for maintaining a reserve ceases" as a year in which any amount received from the sale or disposition of receivables for more than their net tax basis and that the taxpayer ceases to be subject to tax, either under Chapter 2 or Chapter 3. The net tax basis is defined as the face value of the receivables when sold, minus amounts that have been set aside as a reserve for bad debts.

CCR Section 24348(c) states in part "this regulation, however, relates to the treatment of a bad debt reserve when all reason for maintaining the reserve ceases."

The logic of the regulation can be applied when the taxpayer disposes of the receivables yet continues to do business. For example, an S&L may decide to stop making loans with the intent of receiving interest due to the negative spread between the loan interest rate and the rate paid to depositors. The S&L sells their loans but keeps the servicing rights. The S&L continues to do business as a loan broker. They receive income from loan origination fees and servicing fees. Since the S&L no longer has accounts receivable on their balance sheet, it would appear logical that the need to maintain a reserve ceases. The reserve should be taken into account in determination of the net tax basis in the loans sold.

Some entities have attempted to bring a portion of their bad debt reserve into income in a loss year on the premise that it was no longer needed. Before the auditor agrees to such treatment we should insure that:

- There is an identifiable event during the year in question, which makes it logical that a portion of the reserve is no longer needed. For example, a significant number of the loans within the loan base are sold without recourse.

- The beginning bad debt reserve is not overstated. For example, prior to 1977 savings & loan associations were allowed to compute their bad debt reserve based on any twenty years of experience. If they did not have actual experience they could use industry averages. Most savings
and loan associations used experience that included the 1930 Depression years. This resulted in a tax bad debt reserve greatly in excess of book bad debt reserve.

CCR Section 24348(b) was amended in 1976 to allow use of (1) a six-year average, (2) facts and circumstances or (3) the 1976 ending reserve. The theory was that the bank or S&L would in essence use the specific write off method (deductions would be limited to charge offs) until the ending reserve determined under (1) or (2) above exceeds the 1976 ending reserve balance.

The savings & loan industry in California experienced negative charge offs in the late 1970's as the value of the homes repossessed exceeded their basis in the mortgage.

Some S&Ls experienced losses in the early 1980's due to high interest rates on deposits. It would be tempting to include a portion of the reserve in the loss year, as it was no longer needed.

The auditor in such a case should document how long the reserve was over-stated given the pre-1977 computation of the California bad debt reserve. For example, what was the ending reserve prior to 1976 using a six-year moving average or the book reserve compared to the tax reserve. Perhaps the reserve has been overstated for twenty years or more. If so, other than having a loss year, what is the reason for including a portion of the reserve in income?
0420 BUY-DOWNS

A buy-down is a subsidy that is paid by the seller of real property to pay for a portion of the interest that the buyer of the property would normally pay. It normally will cover the first year's interest, and up to the first five years interest. The sellers arrange buy-downs to facilitate the sale of their property. This type of transaction is arranged when the buyer/borrower is either unable or unwilling to buy the property at the prevailing interest rate, but is able or willing to buy at a reduced rate. When this happens, the seller can negotiate with a financial institution for a "buy-down" of the interest rate. To accomplish this, the seller deposits into a savings account a sum of money sufficient, after considering the interest to be earned on the account, to cover the difference in the monthly payments between the prevailing rate and the buy-down rate for the period of time agreed to in the buy-down arrangement. This may range anywhere from 12 to 60 months. This deposit is non-refundable to the seller, even on early payoff or refinancing of the loan. Each month an amount equal to the difference between the two interest rates is transferred out of the savings account and added to the buyer's monthly payment; the resulting payment yielding the required interest rate.

When the institution receives this non-refundable deposit it immediately establishes a deposit liability for the full amount. The normal procedure is then to amortize the buy-down into income on a monthly basis. Since the institution receives this front-end fee without any real restrictions, it should be included in income in the year of receipt. Treas. Reg. Sections 1.446-1(c)(1)(i) & (ii) and 1.451-2, and IRC Section 451.

In the industry buy-down loans are also known as "teaser" or "seller assisted" loans. The liability account might also be classified as mortgagor funds.
0422  CAPITAL COSTS

Some of the costs that are often written off as current expenses are as follows:

- Foreclosure costs—These include such items as back taxes, insurance, and legal expenses as well as substantial repairs and improvements.
- Mortgage expenses—These are expenses incurred in connection with mortgage money.
- Legal expenses—These are expenses incurred in acquiring leases or formulating loans.
- Merger, acquisition, and consolidation expenses.

Capitalization of any of the above costs may be required. Some of the costs will be amortized over the life of the mortgage or loan. Foreclosure costs are taken as part of the cost of the property when it is disposed of. Merger, acquisition, or consolidation costs become part of the cost of the survivor. Before proposing the above or similar adjustments, be sure to consider the ultimate tax effect.

All of the above expenses are of a capital nature and are covered under the capital expenditures section of IRC Section 263 (R&TC Sections 24422 and 24423). For related discussions see Bank & Financial Handbook Section 0472, REAL ESTATE OWNED (REO OR ORE) and Bank & Financial Handbook Section 0486, SALE OF REO: GAIN ON IMPROVEMENTS.
Issues that arise in this area are primarily due to acquisitions/mergers. If one savings & loan acquires another, and they are on different accounting methods, an issue may arise whereby the taxpayer may attempt to recalculate the income of the acquired S&L using the taxpayer's method of accounting. This is to obtain the benefit of its accounting method (for instance the liquidation method) in computing the income of the acquired S&L.

The operative sections in regard to acquisitions/mergers for federal and state purposes are IRC Section 381 and R&TC Section 24471. Taxpayers may attempt to apply IRC Section 481, which would permit the re-computation of income using the acquiring or surviving corporation's accounting method. IRC Section 381 requires that dollar balances be brought over from the acquired corporation. The adjustment made under IRC Section 481 may surface in one of the following ways:

- The taxpayer may file a separate claim for refund based on this adjustment.
- The taxpayer may reduce its loan fee income via a journal entry on the tax spreadsheet. Therefore the tax return does not reflect the change in accounting method adjustment, it having been made prior to bringing income into the schedule M.
- The taxpayer may net the adjustment with other schedule M adjustments.
- The taxpayer may report the change in accounting method adjustment as a separate schedule M adjustment.

The situation will normally arise in an acquisition where different methods of accounting have been used in reporting loan fee income or escrow interest income (e.g. the acquiring corporation uses the liquidation method and the acquired corporation uses either the straight cash or accrual method). When this occurs the taxpayer will re-compute the income of the acquired corporation on a historical basis as if they should have been using the other method (e.g. the liquidation method) all along. The difference in income between this re-computation and the income actually reported over the years in question equals the adjustment claimed by either the acquired or acquiring corporation. The authority for requiring the application of IRC Section 381 vs. IRC Section 481 is that IRC Section 381 is the controlling section of the code. IRC Section 481 is to be applied only in cases where adjustments are necessary to prevent amounts from being duplicated or omitted. Adjustments for a change in accounting method are frequently made pursuant to a revenue procedure. The revenue procedure will identify the conditions for approval of the accounting change including the number of years to spread the Section 481 adjustments. If IRC Section 381 were applied, dollar balances would be brought forward and no duplication or omission of income would result.
0426 COMMITMENT FEES

Commitment or standby fees are charges for making funds available on a standby basis and not for the use of funds. They do not represent interest. These fees may relate to business loans, letters of credit, construction loans or mortgage loans. There are no special rules for reporting income on commitments or standby fees.

Rev. Rul. 56-136 states that since commitment fees are current charges for making business funds available on a standby basis rather than for the use of funds, they do not represent interest expense to the borrower. However, commitment fees are deductible as ordinary and necessary business expenses, and thus would constitute gross income to the bank payee.

The two most common types of commitment fees are for unsecured business loans and mortgage commitments. The business loan commitment is a fee charged monthly on the unused portion of the commitment or line of credit. The fee is billed monthly and usually collected within a few days. You are not likely to find much difference between tax and financial reporting of this item. The mortgage commitment is by nature like an option. The fee is earned and collected at the time the commitment is given. However, you may find that for financial reporting the income is spread over the life of the commitment, thus you should find a schedule M adjustment. If a schedule M adjustment indicates that commitment fees are being deferred, you should determine what kind of commitment fees there are and how each was reported.
0428 CORE DEPOSITS

The Office of the Comptroller of the Currency (OCC) issued circular #164 on December 29, 1981. It provides that banks, under appropriate circumstances could capitalize the value of customer deposit relationships. The FDIC adopted a similar policy on March 5, 1982. Banks intending to record such assets must obtain prior approval from the Comptroller of the Currency and the SEC.

The OCC defines core deposits as the deposit base. The deposit base, while usually not restricted, is generally based on stable customer relationships the bank can expect to maintain for an extensive period of time.

The core deposit issue arises in the acquisition of another bank. The purchaser allocates the purchase price based on fair market value to the tangible assets acquired. Any purchase price over fair market value of tangible assets is generally assigned to goodwill. This is not an issue for book purposes as goodwill is amortized.

For tax purposes, prior to adoption of IRC Section 197, goodwill could not be amortized. Thus, the taxpayer receives no benefit from the amount allocated to goodwill until the asset is sold or otherwise disposed of.

The taxpayer may allege that the reason for the excess purchase price over the fair market value of tangible assets is due to the amount of deposits and that past business practice shows that the deposits will not be withdrawn for some time. Thus, the taxpayer is also purchasing a source of stable money, the core deposits.

IRC Section 167(a) is the controlling provision for the allowance for amortization of intangible assets acquired prior to the enactment date (or election-back date, where applicable) of IRC Section 197. IRC Section 167 provides for a depreciation or amortization deduction for the exhaustion of property used in a trade or business. Although IRC Section 167(a) does not specifically refer to intangible property, Treas. Reg. Section 1.167(a)-3 recognizes that an intangible asset may be amortizable under certain circumstances. Treas. Reg. Section 1.167(a)-3 permits amortization of an intangible asset if the asset is known from experience or other factors to be of use in the business or in the production of income for a limited period, the length of which can be estimated with reasonable accuracy. The regulation denies amortization for intangible assets that do not have limited useful lives, and states specifically that no depreciation is allowable for goodwill.

During 1993, several major changes occurred in the tax law that impact the amortization of intangibles. First, the United States Supreme Court rendered a decision holding that if a taxpayer could prove that an intangible asset had a limited useful life and a value that could be determined with reasonable accuracy, the taxpayer could amortize (or depreciate) the intangible despite how closely the intangible resembled...
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With regard to the taxpayer’s burden of proof, the IRS issue paper states:

“It is also clear from the majority opinion [in Newark Morning Ledger], however, that a taxpayer claiming amortization of a customer based intangible has a substantial burden to establish (1) that the taxpayer has accurately determined the duration of the claimed value of the asset, and (2) that the taxpayer has accurately determined its value. The Supreme Court acknowledged that ‘although we now hold that a taxpayer able to provide that a particular asset can be valued and that it has a limited useful life may depreciate its value over its useful life regardless of how much the asset appears to reflect the expectancy of continued patronage, we do not mean to imply that the taxpayer’s burden is insignificant. On the contrary, that burden will often prove too great to bear.’ 113 S. Ct. at 1681. The Court cited several core deposits cases as examples where the Tax Court and appellate courts had concluded that certain core deposit intangibles could be amortized because those taxpayers had met their burden.”

“In Newark Morning Ledger, the government did not attempt to challenge the taxpayer’s valuation methodology, nor did it challenge the useful life attributed to the ‘paid subscribers.’ Instead, the entirety of the government’s case was its argument that amortization of the asset should be disallowed as a matter of law. Because the government had not developed the case factually, the government lost the case once the Supreme Court held that depreciability of an intangible asset is a question of fact. The lesson of Newark Morning Ledger is that the Service has to factually develop cases involving intangible assets, or else expect to lose these cases.”

“The Service has been relatively successful in those cases where it challenged taxpayers’ valuation methods and useful life assertions. Where taxpayers have inappropriately valued and lifed their intangible assets, the government has been relatively successful in challenging the taxpayers’ claims and has generally prevailed with respect to the dollar amounts of the deficiencies. Thus, Newark Morning Ledger should not be taken as a signal that the Service is reluctant to litigate valuation and useful life issues if the factual development demonstrates that the taxpayer has not proven these elements.”

“The taxpayer must be able to (1) identify the claimed asset, and demonstrate that it does not overlap with other putative intangibles claimed on the return; (2) demonstrate that the customer based intangible has a useful life of limited duration, and the useful life can be established with reasonable certainty; (3) demonstrate the asset’s value with reasonable accuracy, with substantiation in
the form of a proper appraisal; and (4) establish that its method of amortization is a reasonable one.”

“Because a case involving a customer based intangible requires factual development, examining agents are urged to consult a Service engineer or economist (or an outside expert in appropriate cases) for lifing and valuation assistance. Although a taxpayer generally has the burden of proof with respect to the claimed useful life and valuation, the service should always be able to specifically demonstrate why a taxpayer's appraisals or assertions are erroneous. General guidance on critiquing taxpayers’ appraisals may be found in the Intangibles Settlement Initiative Teleconference Handbook, Internal Revenue Service Document 9233 (2-94), Catalog Number 20566N.”

In order to prove the value and useful life, most taxpayers that have acquired businesses with intangible assets of any significant value obtain an appraisal or valuation of the assets acquired. The mere fact that the taxpayer obtained an appraisal report from an independent company that is in the business of valuing assets does not mean that the taxpayer has met its burden of proof. You must determine whether the report was properly prepared, i.e., that its assumptions are correct under the facts.

The appraisal report should contain sufficient detail for you to have a full understanding of how the value was determined (the methodology), the assumptions that were used, and the source of the data utilized. You should be able to trace the raw data numbers into the report and verify the information presented. If you are not able to do this, then chances are you do not have enough information to determine the adequacy of the appraisal. You must request additional information from the taxpayer or have the taxpayer walk you through the appraisal process that took place.

- **Nature of the Appraised Asset**

Begin by identifying the intangible assets that are at issue in the case. Be sure to have a complete understanding of the nature of the asset. Sometimes a taxpayer will place a creative label on an intangible asset. You need to understand what that asset represents.

Once you understand the nature of the asset that the taxpayer is claiming, then you need to determine whether the individual elements that the taxpayer valued are actually components of that asset. For example, since a core deposit is to represent the cost savings of using the core deposit as a source of funds rather than alternative sources, if the deposit is interest sensitive, i.e., it bears a market rate of interest, then it cannot be part of the core deposit base. Additional information will follow with an explanation of relevant decisions.

- **Statistical Sampling**
Most reports do not examine 100% of the components of the intangible assets, but instead will statistically sample the elements. For core deposits, they will not trace the history of all bank accounts ever opened at each branch but will select only a portion. The sample size must be sufficiently large enough to produce reliable results. In *Newark Morning Ledger*, 460,000 accounts were included in the sample size and this was considered large enough. In *Ithaca Industries, Inc. v. Comm.* (4th Cir. 1993) 17 F.3d 684 a case that involved the amortization of an assembled workforce, the court stated that a sample size of only 5,000 different people was not sufficient to identify pertinent variables and reliable patterns of attrition.

The taxpayer must stratify the components of the asset into groupings if very different decay or runoff rates are expected for different groups. If the purchased intangible's components have not been properly broken down, then the appraisal is subject to inaccuracies that may be unreasonably acceptable. Make sure that the percentage of each category sampled is high and that the overall dollar value that was sampled is also high (90% range).

- **Assumptions Used**

Make sure that the assumptions used are reasonable under the circumstances. Look at the discount rate, alternative costs of funds, etc. If you do not understand why an adjustment was made or why a particular figure was used, ask the taxpayer.

- **Methodology**

For core deposits, the Tax Court has approved the use of the cost savings methodology for the measure of the value of the core deposit base. (See *Trustmark Corp., et al. v. Comm.* (1994) T.C. Memo 1994-184 and *Citizens & Southern Corp. v. Comm.* (1988) 91 T.C. 463.) Under this approach, the value of the core deposit is equal to the present value of the difference between the asset's ongoing cost and the cost of the next most favorable market alternative.

With regard to valuations, the IRS issue paper states:

“The in Newark Morning Ledger, the Supreme Court sanctioned the INCOME APPROACH for valuing customer-based intangibles. This approach is an appraisal methodology that measures the present value of future net income to be received from the customers existing on the date of acquisition, over the useful life of the asset. The income stream attributable to a customer based intangible:

- Must be determined based on the actual full term of the income stream, not its average life.
- Must be NET.
• Must not include the return on any other asset (no double counting).
• Must be consistent with all other valuation assumptions made by the taxpayer.
• Should consider future income from only those customers of the acquired concern on the acquisition date. THE INCOME STREAM SHOULD NOT REFLECT INCOME FROM FUTURE OR REPLACEMENT CUSTOMERS.
• Should include an after-tax discount rate that reflects the speculative nature of the asset (i.e., should reflect a higher discount rate for more speculative assets), and should use a higher discount rate for the specific asset as compared to the discount rate appropriate in valuing the business as a whole. If the rate used is not at least as high as the taxpayer’s actual return on equity, further inquiry will be necessary.
• Should NOT be increased by an inflation factor.
• Should identify the costs (both direct and indirect) identifiable with the asset being valued.

“Net after cash flow may include a ‘tax shield,’ i.e., the present value of the tax savings attributable to the amortization deduction. See IT&S of Iowa, Inc. v. Commissioner, 97 T.C. 496 (1991), and Peoples Bancorporation v. Commissioner, T.C. Memo, 1992-285, where the court sanctioned the use of a tax shield. The after-tax cost savings may be computed in either of two ways. In Citizens & Southern and Colorado National Bankshares, for example, an effective tax rate of 20% was applied to cost savings unreduced by the amortization deductions. Alternatively, the statutory tax rate can be applied to the cost savings reduced by the amortization deductions. However, be alert to a flawed computation which applies an effective tax rate to cost savings reduced by the amortization deductions because the tax benefit of amortization is already included in the effective tax rate. IT&S of Iowa, Inc. v. Commissioner, supra, 97 T.C. at 532-533. See, e.g., Trustmark Corp. v. Commissioner, T.C. Memo, 1994-184.”

“If the taxpayer is using a COST METHOD, this is acceptable. This method is based on the cost to replace or recreate the property or property of equivalent utility. Preferably, costs used should be the actual cost figures experienced by the taxpayer, as these are most indicative of the replacement cost. However, if these are unavailable, cost data of the industry is acceptable. Note that in applying the cost approach, accumulated obsolescence from all sources must be taken into account.”

Useful Life

The taxpayer must perform a lifing study or lifing analysis to determine the useful life of the asset. A lifing study typically considers three factors: (1) the number of open accounts at or near the date of acquisition; (2) the age of the accounts at the time; and (3) the rate at which the accounts were expected to terminate.
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as a function of their current age. The rate at which accounts will close is usually assumed to be the same as the rates at which past accounts closed. These rates are determined by observing prior account closures over a certain period of time. The Tax Court has deemed as reasonable periods ranging from three months to three years. (See Trustmark Corp., et al. v. Comm. (1994) T.C. Memo 1994-184.)

Often the lifing study will be part of the appraisal report. The life of the asset will determine its value if the income method is used because income is projected over the estimated life of the asset, then discounted back to the date of purchase. The terms discussed above under Appraisal Reports apply with regards to the determination of the life as well as the value of the assets.

The IRS issue paper states:

“The fact that the customer based intangible has a limited useful life must be demonstrated by the taxpayer. Additionally, the duration of the useful life must be established. THE LIFE WHICH IS RELEVANT FOR AMORTIZATION PURPOSES IS THE ACTUAL, ENTIRE LIFE OF THE COMPOSITE WHOLE, AND NOT THE AVERAGE LIFE OF THE UNITS COMPRISING THE CUSTOMER BASED ASSET. Where statistical methods have been used to project the life of an intangible asset, the statistical projection should be compared with the taxpayer’s actual post-acquisition experience. Lifting studies should, where possible, be reviewed by a statistician to identify lifting methodologies that are inconsistent with general statistical principles.”

“The taxpayer may not ignore the above-normal life of certain stable customer relationships, such as commercial accounts or long-term supplier relationships.”

Wasting Nature

Goodwill and going-concern value have not been subject to amortization (prior to the enactment of IRC Section 197) because they are not wasting in nature (there is no exhaustion of the asset). In Newark Morning Ledger, supra the U.S. Supreme Court defined goodwill as "the expectancy of continued patronage." It is composed of all of the qualities that attract customers to the business. In order to separate an asset from goodwill, the taxpayer must show that public taste or other socioeconomic forces will cause the intangible asset to be retired from service. The mass asset rule prohibits the amortization of certain customer-based intangibles on the grounds that those assets are self-regenerating. Although the assets may change, they never waste.

Amortization Method
Generally, intangible assets are to be amortized over their useful lives on a straight-line basis. If, however, the taxpayer is able to prove that an accelerated method results in a more reasonable depreciation allowance, an accelerated method can be used. (See Trustmark Corp., et al. v. Comm. (1994) T.C. Memo 1994-184; IT&S of Iowa, Inc. v. Comm. (1991) 97 T.C. 496; and Citizens & Southern Corp. v. Comm. (1988) 91 T.C. 463.)

The IRS issue paper notes:

“The STRAIGHT LINE METHOD is generally acceptable. If an accelerated method is used, it must be consistent with the rate that the customer based asset (not its present value) is projected to waste for valuation purposes.”

Definition of Core Deposit

The IRS in its issue paper defines core deposits as “stable deposits which a bank or savings & loan association expects to retain for an extensive period of time, but which the depositors may terminate at will. The intangible is associated with the present value of the future cost savings from acquiring low cost core deposits to fund a bank’s earning assets, instead of more expensive sources of investible funds. The core deposit intangible is also referred to as deposit base.” Assembled workforce represents the value inherent in having a trained staff of employees in place and is limited to employees who do not have employment contracts.

The Tax Court in Citizens and Southern Corp. v. Comm., (1988) 91 T.C. 463 defined core deposits as "a relatively low-cost source of funds, reasonably stable over time, and relatively insensitive to interest rate changes."

Citizens and Southern Corp. included regular savings accounts, NOW accounts and certificates of deposit (CD) in their definition of core deposits. The taxpayer did not include money market accounts in core deposits.

The IRS took the position that the core deposits were an element of goodwill. The IRS did not take issue with the make up of the accounts Citizens and Southern Corp. included in their core deposits.

In IT&S of Iowa, Inc. v. Comm., 97 TC 496 the IRS took issue with the definition of core deposits. The Tax Court noted that in Citizens and Southern the taxpayer defined core deposits to include CDs. The inclusion of CDs in Citizens and Southern was not relevant to other taxpayers as "we did not consider the breadth of the core deposit definition because it was not contested by respondent."

IT&S of Iowa, Inc. included all deposits except certificates of deposit over $100,000, internal accounts and government funds. The IT&S of Iowa, Inc. definition of core deposits included demand accounts, savings accounts, super NOW accounts, money market accounts, and CDs under $100,000.
The Tax Court rejected the taxpayer's definition of core deposits as being overly broad. The Court defined core deposits as "a relatively low-cost source of funds, reasonably stable over time, and relatively insensitive to interest rate changes."

"If deposits bear a market rate of interest and are sensitive to market rate fluctuations, they offer no potential for extra-normal profitability and there is no potential for cost savings associated with them. If, however, deposits are insensitive to interest rate changes, they do offer the possibility of providing above normal profits, and, accordingly, will command a premium in a sale transaction."

The Tax Court in *IT&S of Iowa, Inc.* goes on to note that "adjustable rate deposit accounts, such as certificates of deposit, money market accounts, and super NOW accounts, were expressly created in order to allow banks to compete successfully for deposits against financial intermediaries not bound by interest rate ceilings applicable to banks. Inasmuch as such accounts were designed to be interest rate sensitive and rate competitive products of banking, it is illogical to include them automatically in core deposits, a term defined to mean deposits which are not sensitive to interest rate changes."

While such accounts are not automatically excluded from core deposits, there must be a showing that the accounts are insensitive to interest rate changes. The court looked at such indications as market competition and the relationship between the taxpayer's interest rate and market rates. The Tax Court in *IT&S of Iowa, Inc.* excluded CD's and money market accounts from the definition of core deposits. A similar conclusion was made in *Peoples Bancorporation and Subsidiaries v. Comm.* (1992) T.C. Memo 1992-285.

In *Colorado National Bankshares, Inc. v. Comm.*, (1990) T.C. Memo 1990-495 the taxpayer only included interest free checking accounts, NOW accounts and savings accounts.

It appears that the Tax Court took a common sense approach to the idea of core deposits. While the IRS was correct in that many aspects of core deposit valuation relate to goodwill (what are the odds that the depositor will leave their account at that branch), it makes common sense that a source of funds at 5.5% is more valuable when replacement funds costs 8%. Someone would pay a premium to acquire a lower cost source of funds.

At the same time, the Tax Court found that it was illogical to say that funds which are at or near the market interest rate qualify as core deposits as they do not have the ability to earn above normal profits.

In *Trustmark Corp., et al. v. Comm.* (1994) T.C. Memo 1994-184, the Tax Court relied heavily upon the definition of core deposit that it set forth in IT&S of Iowa. The court stated that it did not foreclose the
possibility of including money market accounts and Super NOW accounts in the deposit core in situations where the taxpayer could show that such deposits were in fact insensitive to interest rate changes.

Once the core deposit has been defined, the cost to the bank, both in terms of explicit interest and the cost of services provided to depositors, called implicit interest, must be ascertained.

Cost of Alternative Funds

The cost savings methodology measures the present value of the difference between the cost of an asset and the cost of the next most favorable market alternative. In Trustmark Corp., Inc., et al., the taxpayer used insured certificates of deposit as the alternative source of funds because of their similarity to core deposits in terms of insurability, average balance size, and maturity or remaining life. The court accepted this as a reasonable basis for comparison. In IT&S of Iowa, the court suggested that the best sources of comparison are the rates paid by the taxpayer on interest rate sensitive deposits. In Trustmark, the court found that competitor's CD interest rates are a reasonable cost of alternative funds to the taxpayer.

After-Tax Cost Savings

In computing the after-tax cost savings, the taxpayer may either apply an effective tax rate (i.e. a rate that is lower than the actual tax rate) or it may reduce the pre-tax cost savings by the amortization deduction, but it cannot do both. (See Trustmark Corp., et al. v. Comm. (1994) T.C. Memo 1994-184; Citizens and Southern Corp. v. Comm. (1988) 91 T.C. 463.

Discount Rate

The discount rate to be applied usually consists of the weighted cost of debt and equity capital. The specific facts of the case, however, can impact the discount rate. (See Trustmark Corp., et al. v. Comm. (1994) T.C. Memo 1994-184.)

Audit steps should include:

1. Has the IRS audited this issue? Did the IRS make a settlement offer pursuant to the IRC Section 197 settlement program? Did the taxpayer accept the offer or make a counter-offer that the IRS accepted? If the answer to all of these questions is yes, then we will follow the federal agreement.

2. Determine how the taxpayer is treating the transaction for book purposes. Did they place a separate value on the core deposit intangible and amortize it over the same period and method as for tax purposes or is it included in goodwill? Ask the taxpayer to reconcile any difference in treatment between
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the intangible was acquired. Thus, where the acquisition took place prior to January 1, 1994, the California amortization period will be less than 15 years. The amortization is taken ratably over this period.

Under the example above, the taxpayer would begin the amortization period on January 1, 1994, and would end it in August of 2008 (14 years, 8 months or 176 months). Rather than claiming an amortization deduction of $10,000 for 1994 (the federally computed amount), the taxpayer would be entitled to $10,227 ($150,000 divided by 176 months times 12 months).

R&TC Section 25355.5 provides that any election made at the federal level under IRC Section 197 is binding for state purposes. Thus there is no ability to make a different election for state and federal purposes concerning purchased intangibles.

We have also decided to follow the IRS settlement initiative with regards to the amortization of intangibles acquired prior to the enactment of IRC Section 197. We will follow whatever determination the IRS made, if there has been an audit by the IRS on the intangible issue. If the IRS decided to apply the settlement initiative, including adjustment of the useful life in lieu of the basis adjustment, we will do the same. If the IRS refused to settle the issue, then we will likewise go forward with the factual development of the issue. Hopefully, the taxpayer would agree in that case to wait until there is a final federal determination so that we do not have to duplicate audit efforts. If the IRS has not audited this issue, then we can apply the IRS settlement process rules to the case. Once the basis adjustment has been determined, a closing agreement is entered into with the taxpayer setting forth the basis of the assets, the useful life, and the method of amortization. The closing agreement must be prepared by legal. If the taxpayer wants to settle the issue in a manner that is outside the guidelines set forth by the IRS, then the matter must go through the regular settlement process and meet all of the guidelines for that process.
0430  CREDIT CARD FEES

Most commercial banks that provide customers with credit card services charge an annual fee for those services. In situations where the banks, financials, or savings & loans are accrual basis taxpayers, the IRS has questioned whether the entire annual fee for the credit card contracts should be included in income in the taxable year in which the contract begins. Or should the fee be included in income on a straight-line ratable basis over the one-year time period of the contract agreement. The IRS has taken the position that the annual fee should be reported when received or when it is due and payable under the accrual basis (whichever is earlier). Before approaching this type of adjustment, be sure that any potential tax change is material.
0434   DIVIDENDS FROM FNMA STOCK

Dividends received from Federal National Mortgage stock are taxable in the year received, per Rev. Rul. 56-510.
0436 EARLY WITHDRAWAL PENALTIES

Many financial institutions offer fixed term certificates with early withdrawal penalties. For example on July 1, year 1 you may purchase a $10,000 one-year certificate of deposit which pays 10% interest. Assuming the financial institution is on a calendar year end and the account including interest is withdrawable on demand, the financial institution would deduct interest expense of $500 (10,000 x 10% x 1/2 year) during year 1.

Assume you withdraw your deposit on 1/1/year 2. Also assume that the financial institution has an early withdrawal penalty of the difference between the interest rate paid and the passbook rate. If the passbook rate is 5%, the penalty would be $250 [(10,000 x (10% - 5%) x 1/2 year]. Thus you would receive $9,750 from the financial institution. The question for tax purposes is if the early withdrawal penalty is current income.

A series of court cases has established the tax benefit doctrine. This doctrine established that the recovery of amounts previously deducted requires the inclusion of the amount in taxable income. IRC Section 61(a)(12) also provides that forgiveness of indebtedness is taxable income. IRC Section 108 limits the application of Section 61(a)(12) and the tax benefit rule in certain cases involving discharge of indebtedness income.

Prior to the enactment of the Tax Reform Act of 1986, the taxpayer could reduce the basis in assets for income from discharge of indebtedness if the discharge is from qualified business indebtedness (IRC Section 108).

Many banks and financial corporations, especially savings & loan associations, have taken the position that the early withdrawal penalty is a discharge of indebtedness within IRC Section 108 and as provided by Section 1017 elect to reduce the basis in assets, deferring the recognition of income. Before June 2, 1980, penalties charged on early withdrawal of depositors' account were calculated based upon the number of days the certificates were held. Generally, interest is accrued throughout the year and credited to the depositor's account. The interest portion was subject to withdrawal by the depositor. The penalty was based on the interest paid to time of withdrawal of principal.

The 1980 Financial Institutions Deregulation and Monetary Control Act required the FHLBB, the Comptroller of the Currency, and the FDIC to issue new regulations.

Effective June 2, 1980, the following minimum penalties are imposed on early withdrawal:

- 90 days interest for certificates of deposit with a term of less than one year.
- 180 days interest for certificates of deposit with a term over one year.
The regulations provide that the depositor's principal may be reduced if the penalty exceeds the interest remaining in the account.

Rev. Rul. 83-60 states that early withdrawal penalties do not qualify for forgiveness of indebtedness and thus cannot be excluded from income under IRC Section 108. Rev. Rul. 83-60 also provides a copy of part of the regulation on the new early withdrawal penalties.

Although Rev. Rul. 83-60 applies to all banks and financial corporations the ruling specifically refers to IRC Section 591 and Treas. Reg. Section 1.591-(b) in regards to domestic building and loan associations and certain other thrifts. The regulation states that these financial institutions may deduct the full amount of interest credited and available to the customer even if it is subject to an early withdrawal penalty. If the penalty is later imposed, the penalty must be included in taxable income. R&TC Section 24370 is similar to IRC Section 591.

The U.S. Supreme Court in *U.S. v. Centennial Savings Bank FSB* (1991) 499 U.S. 573 affirmed the IRS position in Rev. Rul. 83-60 in that early withdrawal penalties are not a discharge of indebtedness and must be included in taxable income.

This should not be an audit issue for withdrawal penalties generated after 1986 by a solvent bank or thrift given the Tax Reform Act of 1986 amendments to IRC Section 108.
0440 FOREIGN EXCHANGE

Generally Accepted Accounting Principles (GAAP) for the translation of foreign currency for financial accounting developed in response to changes in the international monetary system. Prior to 1920 foreign currency translation was not a material issue. Although commodities were exchanged over international boundaries, few U.S. corporations had foreign subsidiaries or branches, thus most transactions were translated at spot rates.

The accounting profession first addressed the issue in 1931 in a report called "Foreign Exchange Losses" which recommended basing foreign exchange gain or loss on classification of assets and liabilities as current or non-current. In 1939 the AICPA published Accounting Research Bulletin (ARB) No. 4 "Foreign Operations and Foreign Exchange Gains," which used the current/non-current method of foreign exchange. The current/non-current method provides that current assets and liabilities are translated at year-end exchange rates. Non-current assets and liabilities are translated at historical cost and exchange rates on date of acquisition.

During 1944 - 1971 exchange rates were stable. The international monetary system was controlled by the Articles of Agreement of the International Monetary Fund. It was adopted by most major countries in 1944, and was commonly referred to as the "Bretton Woods Agreement." The monetary system was based on having most currencies valued by reference to the U.S. dollar. The value of the U.S. dollar was based on the supply of gold. The currency of all member countries was based on a pegged rate with the U.S. dollar. The pegged system was dependent on a number of items including uniformity in Central Bank policies of member countries, balance of payments, health of individual member economies and politics among member nations.

Exchange rates were stable until the late 1960's. Member countries refused to devalue their currency due to inflation worries, unbalance of payments of member countries, the demand for the U.S. dollar exceeded the supply, and finally by 1968 the United States had developed significant payment deficits which resulted in fluctuation of exchange rates.

In 1971 the U.S. dollar was devalued and a new set of pegged rates were established in the "Smithsonian Agreement." The United States then went off the gold standard and in 1973 the U.S. devalued the dollar again. As a result of these events a modified floating system was developed which is still in use today.

The currency of the 12 major countries is theoretically set by supply and demand. Central Banks of the various countries are free to purchase and sell foreign currencies to affect exchange rates. Other currencies are valued under a modified version of the floating rate or under a pegged system.

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In 1953, ARB 4 was replaced with ARB 43, "Foreign Operations and Foreign Exchange" which substantially continued with prior methods of current vs. non-current exchange translation.

Due to exchange rate fluctuations of the early 1970’s the Financial Accounting Standards Board (FASB) was forced to study the issue. The study eventually became FASB Statement No. 8. This was a significant departure from prior methods. Basically FASB Statement No. 8 provided that:

- Cash, receivables and payables (both current and non-current) are translated at current exchange rates.

- Assets and liabilities carried at past exchange rates, for example fixed assets, are translated at historical rates.

- Assets and liabilities carried at current purchase or sale exchange rate or future exchange rate, for example inventory valued at market as provided by the lower of cost or market method, are translated at current exchange rates.

- Income and expenses are translated at average rates, except for depreciation and inventory for cost of goods sold, which are translated at historical rates. An exception to the use of the historical rate is, if the inventory is valued at market as provided by the lower of cost or market method, then the average rate should be used.

- Unrealized foreign currency gains or losses will be included in income.

Under prior GAAP pronouncements current assets and liabilities were translated at current rates. Under FASB #8 certain current assets and liabilities such as cash are translated at current rates while other current assets such as inventory (if valued at other than market) use historical rates.

FASB #8 resulted in much criticism. Due to this criticism the FASB sponsored another study that resulted in FASB #52 "Foreign Currency Translation." The two major areas covered by this statement are:

- The accounting and reporting of foreign currency transactions, including forward exchange contracts.

- The translation of foreign currency financial statements for purposes of consolidation, combination or reporting on the equity method.

The difference between foreign currency transactions and translation is that a foreign currency transaction is a transaction that requires a settlement in other than the functional currency of the reporting entity. Translation is the restating of foreign financial statements in the reporting currency of the parent (usually U.S. dollars).
FASB #52 requires a determination of what is the functional currency of the foreign operations. Functional currency is defined as the "currency of the primary economic environment in which the entity generates and expends cash." The following two examples help define functional currency:

- The functional currency of a self contained foreign operation, located in a particular country, whose daily operations are not dependent on the parent's functional currency would use the currency of the country where they are located as the functional currency. This type of entity generates and expends funds in the foreign currency and net cash flows are reinvested in the foreign country, or distributed to its parent. This may be a manufacturing entity whose cost of goods sold is from the foreign economy.

- The second example is that of a foreign entity which is a direct and integral component or extension of the parent's operation. The purchase and sale of assets are made in U.S. dollars and changes in individual assets and liabilities of the subsidiary effect the cash flow to the parent. The functional currency of the foreign operation would be the reporting currency of the parent, most likely U.S. dollars. This type of operation may be a marketing or sales entity.

Basically FASB #52 provides for the following:

- Foreign currency statements must be in conformity with U.S. GAAP prior to translation.

- Assets, liabilities, and operations of the entity are translated in the functional currency of the entity.

- The current rate of exchange shall be used to translate the foreign assets and liabilities to reporting currency.

- The weighted-average exchange shall be used to translate revenue, expenses, gains, and losses from the functional currency to the reporting currency.

- The current rate of exchange shall be used to translate changes in financial position other than accounts that effect the income statement which use weighted average exchange rates.

- If a foreign entity's books are not kept in the functional currency, then the books must be re-measured into the functional currency prior to translation. For example, a U.S. parent may have a self-contained foreign subsidiary located in Germany. The German subsidiary may have a branch located in France. The functional currency is most likely...
German marks. The branch operation's books kept in French francs must be re-measured in German marks (the functional currency) before translation into the reporting currency of the parent.

- Unrealized foreign currency gains or losses are not reflected in the parent's current income except:
  
a. Where the foreign books are re-measured, such as in the example above.
  
b. Where foreign operations are located in a highly inflationary economy. FASB #52 defines a highly inflationary economy as one that has experienced inflation over three consecutive years of 100% or more, i.e., an inflation rate averaging 35% per year. Under FASB #52, operations in highly inflationary economies do not have a functional currency. The functional currency of the parent is used as the functional currency of the foreign operations.

- Unrealized foreign currency gains or losses, except from re-measurement, are separately stated as a component of owner's equity. The accumulated translation adjustments are taken into account in measuring the gain or loss on sale of the investment of the foreign operations. If 50% of the stock in the subsidiary is sold, then 50% of the accumulated translation adjustments are included in determining the gain or loss.

- Gains and losses from foreign currency transactions are recognized in current income, except for:
  
a) Gain or loss from a currency hedge to protect the investment in the foreign operations.
  
b) Gain or loss from certain long-term inter-company transactions.
  
c) Gain or loss on a hedge transaction to protect a foreign currency commitment.

- Deferred income tax treatment and disclosure provisions are also discussed in the FASB.

Prior to the Tax Reform Act of 1986, there was no comprehensive body of law explaining the tax treatment of foreign currency gains and losses in a coordinated manner. Instead, there were general guidelines provided by various court decisions, IRS rulings, and regulations. For example:

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• Where a loan received in foreign currency is repaid in foreign currency, taxable income results if the dollar value of the loan received, converted at the rate of exchange at the time of the loan, exceeds the dollar value of the foreign currency repaid, converted at the date of repayment. (William Helburn Inc. v. Comm. (1st Cir 1954) 214 F2d 815).

• Basis of property purchased with foreign currency is translated to U.S. dollars at the exchange rate on the purchase date. (Rev. Rul. 78-281).

• If the foreign loan is qualified business indebtedness described in IRC Section 108, the taxpayer may elect under IRC Section 108(c) to reduce the basis of depreciable property as provided by IRC Section 1017 for foreign exchange gains. Kentucky & Indiana Terminal Railroad Co. v. Comm. (6th Cir. 1964) 330 F2nd 520.

Except for some instances under Subpart F, federal tax law did not include unrealized gains or losses in current income.

The Tax Reform Act of 1986 added Subpart J (IRC Sections 985 through 989). The purpose of Subpart J is to provide comprehensive rules for the taxation of foreign currency gains and losses, as well as their source and characterization.

Subpart J adopts the functional currency concept of FASB #52. Under Subpart J, foreign subsidiary or branch financial statements whose functional currency is not the U.S. dollar are translated into the taxpayer's functional currency using the profit and loss method. This method has the effect of deferring unrealized foreign gains or losses.

Federal corporate income tax law is similar to California personal income tax in that both subject all income to tax. The problem of double taxed income is handled by the foreign tax credit (federal law) and credit for taxes paid to another state (California law).

Branch income of a U.S. corporation would be included in the federal 1120. The auditor should carefully review the 1120 when the taxpayer has foreign branch operations to insure the correct income and factors are being used for California tax purposes, if this is a material issue.

CCR Section 25106.5-3 provides rules for inclusion of foreign country operations in a combined report. Whenever combination with foreign country operations will result, the regulation should be read carefully.

Departmental policy is that exceptions to the application of CCR Section 25106.5-3 must be fully supported in the audit file. It is recognized that full taxpayer cooperation is required to follow the regulation. The auditor should, through letters and information requests, document that we requested the information necessary to apply the regulation.
CCR Section 25106.5-3 provisions include:

- Unrealized foreign currency gains or losses are not included in income.
- Depreciation, depletion, and amortization shall be translated at the date of asset acquisition.
- Fixed assets and inventory shall be included in the property factor at the historical cost and the exchange rate at the date of acquisition.

Problems immediately arise if we use the annual report for foreign income and total factors including:

- Under FASB #8, unrealized gains and losses are included in current income.
- Under FASB #52:

  Unrealized gains or losses may be included in current income if the foreign financial statements are subject to re-statement, for example, if the foreign operation is in a highly inflationary country.

  Depreciation and inventory for cost-of-goods sold are translated at weighted-average rates.

  Assets are stated at current exchange rates for balance sheet presentation.

The auditor needs to thoroughly study the related FASB in order to know what questions to ask the taxpayer so that CCR Section 25106.5-3 can be correctly applied.
0442 FSLIC & RTC Payments Received Pursuant To A Supervisory Merger

Prior to August 1989, the Federal Savings and Loan Corporation (FSLIC) was responsible for insuring deposits in savings & loan institutions, rescuing failing savings & loan associations, and protecting deposits in failing S&Ls. Because of massive losses in the S&L industry during the 1980s, FSLIC had a large number of S&Ls in serious financial difficulty. FSLIC could either allow the savings & loans to fail and then pay off depositors, or it could provide large infusions of capital to those institutions, making them attractive to new management groups to acquire the failing institutions and attempt to manage them profitably. FSLIC preferred the latter choice. The infusions of capital went directly to the acquiring institution to protect the acquiring institution against future losses, because the value of the liabilities, primarily deposits, were greater than the value of the assets available in the failing institution.

Generally, a taxpayer may claim a deduction for a loss on the sale or other disposition of property to the extent that the taxpayer's adjusted basis for the property exceeds the amount realized on the disposition, and the loss is not compensated for by insurance or otherwise (IRC Section 165). There were, however, some special provisions for troubled savings & loan associations during the 1980s.

Federal Law

For Federal purposes, the acquisitions of a failing S&L by a new management group was considered to be a tax-free reorganization under IRC Section 368(a)(1)(G). Additionally, based on IRC Section 597, financial assistance received by the acquiring group from FSLIC was not considered income and did not require an adjustment to the basis of assets received in the acquisition.

IRC Section 597 (effective for FSLIC payments made after December 31, 1980, and repealed for transactions occurring after May 10, 1989) excluded from gross income of a domestic building & loan association, money or other property received from FSLIC. It also prohibited a reduction in the tax basis of the thrift institution's assets on account of the receipt of the assistance. The combination of the tax-free reorganization treatment and the exclusion of FSLIC payments from income, or as an adjustment to basis, resulted in the acquiring institutions obtaining large tax benefits from their acquisitions of failing savings & loan institutions.

This Technical and Miscellaneous Revenue Act of 1988 reduced this favorable treatment. Taxpayers generally were required to reduce certain tax attributes by one-half the amount of financial assistance received from FSLIC pursuant to certain acquisitions of financially troubled thrift institutions occurring after December 31, 1988.

Section 13324 of the Revenue Reconciliation Act of 1993 further modified the treatment of FSLIC assistance payments. For acquisitions occurring prior to May 10, 1989 (and financial assistance credited on or after March 4, 1991) any FSLIC assistance with respect to any loss of principal, capital, or similar
amount upon the disposition of an asset, must be taken into account as compensation for such loss for the purpose of IRC Section 165. Any FSLIC assistance with respect to any debt must be taken into account for purposes of determining whether such debt is worthless (or the extent to which such debt is worthless) and in determining the amount of any addition to a reserve for bad debts.

**California State Law**

For income years beginning on or after January 1, 1988, the State of California adopted R&TC Section 24322. This section excluded FSLIC assistance from gross income, regardless of whether a note or other instrument was issued in exchange. It therefore precluded a reduction in the basis of assets of a domestic building and loan association on account of money or other property received from FSLIC. It mandated an allowance for deductions, even for those deductions allocable to amounts excluded from gross income under this section. This section applied to payments received prior to December 31, 1988, or for FSLIC payments made pursuant to an acquisition or merger that occurred on or before December 31, 1988. This section included a sunset date of December 31, 1988.

**Resolution Trust Corporation**

The Resolution Trust Corporation (RTC) was created in August 1989 by enactment of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA). As part of FIRREA, FSLIC was dissolved and the Federal Deposit Insurance Corporation assumed FSLIC's inventory of failed savings & loan associations. From August 1989, to December 31, 1995, the RTC was appointed to administer the various receivership and conservatorship estates of approximately 730 different failed S&Ls in the United States, a number of which were doing business in California.

Under federal law, the RTC has great power and latitude in the manner in which it acted as a receiver of a failed savings & loan association.

Typically, the RTC assumed control and acted as a receiver of an insolvent S&L using the following general procedure. At times the designations, time periods, and methods were different, but the result, from the viewpoint of the State of California and the Franchise Tax Board, has been about the same.

First, the Office of Thrift Supervision determined that an S&L was insolvent and requested the RTC to assume control of the S&L. On day 1, the RTC assumed control of the insolvent S&L and placed it in receivership (Old Receivership). On the same date the RTC created a new “federal mutual de novo association”, a federal corporation, with its own charter, and immediately places this federal mutual de novo association in conservatorship.

In a very short time, on day 1 or within a few days, there was a purchase and assumption agreement between the Old Receivership and the conservatorship. The Old Receivership primarily retained the liabilities (other than deposits), and the conservatorship received the assets with remaining liabilities.
(primarily deposits). The depositors of the failed S&L dealt with the conservatorship for their financial transactions and probably did not realize there was a change.

The prime function of the Old Receivership was to dispose of liabilities, according to the federal claims process provided under FIRREA, for those pre-receivership liabilities that were retained by the Old Receivership. As of the date of receivership, FIRREA exempted the Old Receivership from all local and state taxes other than ad valorem property taxes.

The primary goal of the conservatorship was to continue to service the depositors until the deposits (assets and liabilities as a package if possible) could be sold to another financial institution to avoid a cash pay out to depositors. The conservatorship attempted to dispose of its other assets in the best manner (most profitable) possible.

Always, and normally within six months, the conservatorship, the new federal corporation, was placed into receivership status. This receivership (New Receivership) liquidated the remaining assets, with the proceeds going to the RTC as subrogation to the depositors, whose deposits had been guaranteed and paid by the RTC. As of the date of receivership, FIRREA exempted the New Receivership from all local and state taxes other than ad valorem property taxes.

The Old Receivership, the conservatorship and the New Receivership retained the California corporate number of the Old Receivership as a matter of convenience. The process of insuring deposits and closing down insolvent S&Ls required massive infusions of funds from the federal government, administered by the RTC, with as much as $2 billion required for a single institution.

Conclusion on State Taxability of Federal Financial Assistance

The State of California did not adopt the current IRC Section 597. However, under general tax principles (R&TC Section 24271 and IRC Section 61), federal financial assistance received by the acquiring bank or domestic building and loan association would be taxable if it met the definition of gross income. On the other hand, if the transaction were structured as a loan (thus not income under R&TC Section 24271 and IRC Section 61), federal financial assistance would not be included in gross income.

Current Status

Carryover Losses

There is no legal rationale for an acquiring institution to use carryover losses based on assets acquired in a typical sale by the RTC or FDIC. R&TC Section 24451 creates conformity of California law to IRC Sections 381 and 382. These sections are designed to prevent abuse in trafficking of tax benefits. IRC Section 381 carryovers in certain corporate acquisitions, limits carryover tax attributes to the acquisition of assets of a corporation by another corporation to one of the following situations:
• In a distribution to such other corporation to which Section 332 applies (relating to liquidation of subsidiaries).

• In a transfer to which Section 361 (relating to non-recognition of gain or loss to corporations) applies, but only if the transfer is in connection with a reorganization, described in subparagraph (A), (C), (D), (F), or (G) of Section 368(a)(1).

Neither of the requirements is met by the acquisition of assets from the FDIC or RTC by an acquiring institution. Carryovers are not allowed under the California Revenue and Taxation Code as conformed with IRC Section 381.

IRC Section 382 further provides a limitation on net operating loss carry-forwards and certain built-in losses that qualify under Section 381. Since the acquisition of assets from the FDIC or RTC does not qualify under Section 381, the Section 382 limitations are not applicable.

Priority of Payment by the RTC/FDIC

The National Depositor Preference Act was passed during August 1993. Prior to this act, liabilities for unpaid state taxes were considered administrative expenses according to California law. As such, state taxes were paid prior to paying depositors. After the National Depositor Preference Act, all state taxes were considered general liabilities and were paid after depositors were paid. After the failure of a bank or S&L, it is much less likely that there will be funds remaining to pay general creditors and state tax liabilities after depositors have been paid.

Status of RTC

On December 31, 1995, the RTC was dissolved. By federal statute, the Federal Deposit Insurance Corporation (FDIC) replaced the RTC for any savings & loans' claims, liabilities, or assets that were not fully resolved or disposed of by the RTC. The FDIC has the same powers of the RTC with respect to any unresolved issues. It is expected that any issues with respect to S&Ls, which have the RTC as receiver, will be fully resolved by the end of 1998.
0450 INTEREST INCOME-ACCRAUL FOR TROUBLED LOANS

A question arises when an accrual basis bank or financial corporation should stop the accrual of interest from delinquent loans. Treas. Reg. Section 1.451-1(a) states "... Under an accrual method of accounting, income is includible in gross income when all events have occurred which fix the right to receive such income and the amount can be determined with reasonable accuracy..."

Rev. Rul. 68-220 provides, in part, that where an administrative agency requires a method of accounting as to a particular item, this treatment is not controlling for federal income tax purposes. This is similar to our bad debt reserve regulations. The amount of reserve required by the regulatory agency, or independent auditors, is not important. The facts relied on to determine the reserve is of great importance.

In Greer-Robbins Co. V. Commissioner (9th Cir. 1941) 119 F. 2d 92 it was held that in determining whether the collection of interest was doubtful, the burden of proof was on the taxpayer to show the bad debt character of the accrued interest.

Rev. Rul. 80-361 provides that interest income should be accrued to the point the loan becomes uncollectible. Any accrued interest not collected should be treated as a bad debt pursuant to IRC Section 166(a) and charged off through the bad debt reserve.

The position of the IRS concerning accrual of interest is:

- If a bank, which is subject to supervision by federal authorities or by state authorities maintaining substantially equivalent standards, has been given specific instructions by a regulatory agency that a loan (in whole or in part) should be charged off as a bad debt, then no interest should be accrued on the amount charged off. Previously accrued but uncollected interest should be charged off as well. Interest should continue to be accrued until the date the account is charged off.

- The loan must be charged off to stop the accrual of interest. The regulatory agency may require that the bank stop the accrual of interest on delinquent loans, although they do not have to charge off the loan. Delinquent loans may be defined as loans in which interest has not been paid for a predetermined number of days, i.e., 30, 60, or 90 days. In this example, the policy is not controlling for tax purposes. Interest will continue to be accrued, unless other facts show that it is not collectible.

- Note that many state-chartered banks or savings & loan associations have federal deposit insurance. These entities would need to meet both state and federal regulatory requirements.
• On loans not charged off, the taxpayer must, on a loan-by-loan basis substantiate that the interest is not collectible. See also Bank & Financial Handbook Section 0412, ACCRUED INTEREST TO DATE OF FORECLOSURE.
0452 INTEREST RECEIVED IN EXCESS OF A MAXIMUM AMOUNT (CAP)

Some loan agreements contain provisions that during the term of the loan interest will be charged at a fluctuating rate, but the total interest charged over the life of the loan will be limited to a maximum amount. This maximum amount is called the "CAP" amount. For example, a loan agreement may provide for monthly payments based on interest equal to the prime rate, although the total interest over the life of the loan is limited to 13%. The prime rate for one month may be 15%. The difference between the 15% rate of interest paid and the 13% CAP may be credited to a liability account. Many of the agreements provide that the excess interest paid over the CAP is forfeited to the lender if the mortgage is paid off early.

A reconciliation of payments made during the life of the loan and the maximum interest allowed is done at the end of the loan term and an additional charge or refund will be made.

The audit issue is, if the amount paid in excess of the CAP is current income or a liability?

Treas. Reg. Section 1.451-1 provides that under the accrual method of income, income is included in gross income when all events have occurred which fix the right to receive such income and the amount can be determined with reasonable accuracy.

Rev. Rul. 66-347 states that a taxpayer must include in gross income, payments where the taxpayer has unrestricted use of the cash even if the payment is subject to a contingent liability to return it. The proper tax treatment is to include the payment in income and take a deduction when and if the refund is made.

Corliss v. Bowers (1930) 281 US 376 held that income received unrestricted as to use is current income.

The Tax Court addressed the issue in Continental Illinois Corp. v. Comm., (1989) T.C. Memo 1989-636. The bank stopped the accrual of interest in excess of the cap for tax purposes due to the following:

a) The all events test was not satisfied.
   b) Due to the high probability of repayment the claim of right doctrine did not apply.
   c) The excess payment was a deposit.
   d) Cases on prepaid income did not apply to their facts.

The Tax Court agreed with the IRS that the income could not be deferred. The bank's right to receive the payment was fixed. The potential refund was a contingent liability that did not affect the right to receive the interest in the current year.
0454  LOAN ACQUISITION COSTS

All reasonably identifiable costs applicable to acquiring loans should be capitalized and written off over the average life of the related loans. Legal or similar expenses attributable to making loans, foreclosures, etc. (fees paid to outside brokers, appraisal fees) should also be capitalized and amortized over the life of the loan.

A review of the taxpayer's chart of accounts should disclose the likely accounts where such expenses might be classified. The accounts should then be reviewed for the above types of items. Note: beware of the possibility of a book/tax accounting difference, i.e., the taxpayer may capitalize the items for book purposes and deduct them for tax purposes. Schedule M-1 should disclose any accounting differences.
0454.1 FASB 91 Costs

The Financial Accounting Standards Board issued Statement of Financial Accounting Standard Number 91 (FASB 91), effective for accounting years beginning after December 31, 1987, to provide guidance on the proper treatment of non-refundable fees and costs associated with originating or acquiring loans.

The accounting profession was criticized for being a party in hiding the scope of the problems in the savings & loan industry during the 1980's. One area of criticism was that income was overstated by the industry’s practice of including loan fees in book gross income currently. In response, FASB 91 was issued which calls for the deferral of loan fees.

FASB 91 also requires that the incremental direct costs of making the loan be netted with the loan's fees and the net amount is brought into income over the life of the loan.

The incremental direct costs incurred in originating the loan include: costs that result from and are essential to the lending transaction; and, costs that would not have been incurred by the lender had the lending transaction not occurred. The costs are typically payroll and employee benefits incurred in evaluating the borrowers financial condition, evaluating and recording title, guarantees or collateral, negotiation of loan terms, preparing, processing, and closing the loan transaction.

IRC Section 162 provides for the deduction of all ordinary and necessary business expenses.

IRC Section 263(a) provides that no deduction shall be allowed for capital expenditures.

An issue arises in that are FASB 91 costs period costs, thus deductible under IRC Section 162, or a capital asset per IRC Section 263?

In a recent case addressing this issue, the Court of Appeals specifically rejected any reliance on FASB 91 as a principle to be followed for tax purposes, and ruled that such costs were deductible under IRC Section 162. (See PNC Bancorp v. Commissioner (3d Cir. 2000) 212 F.3d 822.)

Treas. Reg. Section 461-1(a) provides the general rule for the taxable year of deduction which is that any expenditure that results in the creation of an asset having a useful life that extends substantially beyond the close of the taxable year may not be deductible, or may only be deductible in part, i.e., through depreciation or amortization deductions.

The U.S. Supreme Court in Commissioner v. Lincoln Savings and Loan Association (1971) 403 U.S. 345 held that the premium paid into the FSLIC secondary reserve was a capital asset and not currently deductible. The test adopted by the Court requires capitalization of an expense if it serves to create or
enhance a separate and distinct capital asset with an ascertainable and measurable value. The test became known as the separate asset rule.

In applying the separate asset rule the court in *Briarcliff Candy Corp. v. Commissioner* (2d Cir. 1973) 475 F.2d 775 held that IRC Section 263(a) could be applied to intangible assets even though the language in the section only addresses tangible property.

The U.S. Supreme Court in *INDOPCO, Inc., Petitioner v. Commissioner of the Internal Revenue* (1992) 503 U.S. 79, 117 L Ed 226, held that amounts paid for investment banker fees, legal fees, proxy costs, and S.E.C. fees incurred in a friendly take-over were non-deductible capital expenditures rather than currently deductible ordinary and necessary expenses.

The taxpayer argued that *Lincoln Savings* established that the deductibility under IRC Section 162 was the rule rather than the exception. The Court had created an exclusive test for capitalization in that the expenditure must create or enhance an asset to be capitalized.

The Supreme Court in *INDOPCO* told the taxpayer that they "over-read *Lincoln Savings*." *Lincoln Savings* merely holds that creation of a separate and distinct asset may be a sufficient condition for classification as a capital asset. "Although the mere presence of an incidental future benefit—some future aspect—may not warrant capitalization, a taxpayer's realization of benefits beyond the year in which the expenditure is incurred is undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization."

In *PNC Bancorp*, 110 TC 349, 1998 U.S. Tax Ct., it was held that loan origination expenditures are not currently deductible under IRC Section162(a), and must be capitalized under IRC Section 263(a). The loan origination expenditures were incurred in the creation of loans. These loans were separate and distinct assets that generated revenue over a period beyond the current taxable year.

However, the Court of Appeal in *PNC Bancorp v. Commissioner*, supra, reversed the judgment of the Tax Court, holding that the costs at issue were deductible as ordinary and necessary expenses of the banking business within the meaning of IRC Section 162, and that these costs did not fall within the purview of IRC Section 263. The Court noted that loan operations were the primary method of income production for the subject banks, and thus found that expenses incurred in loan origination were normal and routine in the particular business of banking.

The IRS published a notice of proposed rulemaking on January 24, 2002, describing and explaining rules and standards expected to be proposed to clarify the application of IRC Section 263(a) to expenditures (including transaction costs) incurred in acquiring, creating, or enhancing intangible rules or benefits. According to Chief Counsel Notice CC-2002-021, March 15, 2002, the IRS will not litigate certain transaction cost issues while in the process of proposed rulemaking. The IRS will not assert capitalization under Section 263(a) for employee compensation (other than bonuses and commissions
that are paid with respect to the transaction), fixed overhead, or de minimis costs related to the acquisition, creation, or enhancement of intangible assets or benefits. Costs are considered de minimis to the extent they do not exceed $5,000 per transaction.

See Bank & Financial Handbook Section 0456, LOAN FEES.
0456  **LOAN FEES**

Several different types of fees may be charged at the close of escrow when acquiring a mortgage, including:

- **Points** are a charge by the lender to the borrower that is in addition to the stated rate of interest, i.e., an adjustment to the interest yield. Points are paid at the beginning of the loan to reduce the amount of interest charged over the life of the loan. Thus points are the present value of the reduction of interest over the life of the loan.

- **Commitment fees** are charged for entering into an agreement that obligates the lender to keep a loan available at a stated interest rate and loan amount for an agreed period of time.

- **Service fees** represent amounts charged to the borrower by the lender for processing the loan, recording the transaction, credit inspection, appraisal costs, etc.

Rev. Rul. 70-540 provided various rules for the inclusion of the above fees in taxable income. However, Rev. Proc. 94-29 made this revenue ruling obsolete. In general, Rev. Rul. 70-540 concluded that points and service fees which were financed, paid by reducing the loan balance applied to the principal, could be included in the loan liquidation method of accounting, but points and service fees paid in cash were to be included in income currently. Commitment fees were to be included in income when received for cash basis taxpayers and when due or received for accrual basis taxpayers. There is no reason to defer the fees paid in cash from income. However, it has been difficult to audit and enforce cash payments of points and fees because the loan documents are not clear as to which fees and portion of the loan are paid in cash and which are financed. Although the documents may be ambiguous, ambiguity by itself on this issue has not been sufficient to demonstrate fees were paid in cash, not financed, and were improperly included in the loan liquidation method of accounting.

The IRS issued Treas. Reg. Sections 1.1271, 1.1272, 1.1273, 1.1274, and 1.1275, Special Rules for Bonds and Other Debt Instruments on January 27, 1994. The regulations provide guidance on treatment of de minimis OID.

Rev. Proc. 94-29 was issued in April 1994. Rev. Proc. 94-29 provides:

- The use of the principle-reduction method is limited to the accounting for *de minimis OID*.

- There are certain cut-off dates depending on taxpayer elections. The earliest cut off date is December 22, 1992 while the last cut off date is the first day of the tax year after April 4, 1994.
• That the principal-reduction method only applies to loans originated by the taxpayer and the loans produce ordinary income or gain when sold or exchanged.

• That the loans must be separated into sufficiently homogeneous groups.

• That the principal-reduction method only applies to loans that do not have OID or have de minimis OID.


Many S&L's continued to use the loan liquidation method, a permissible method for cash basis accounting even though they were required to change to the accrual method of accounting as a result of the Tax Reform Act of 1986. The Internal Revenue Service will not require a change of accounting method from the loan liquidation method even though the taxpayer is no longer using the cash basis method of accounting.

Rev. Proc. 94-28 and 94-30 are guidelines for change in accounting procedures to conform to Rev. Proc. 94-29.
Savings & loan associations traditionally have held loans to maturity for the most part. Prior to 1980 the Federal Home Loan Bank Board (FHLBB) required S&Ls to deduct any losses from mortgage sales.

In the early 1980's most S&Ls held mortgages at low interest rates compared to market rates at the time. If the loans were sold for cash in a closed transaction, the S&L would have a loss of 30 to 50 percent of their basis in the loan. In many instances this would result in the S&L having a negative net worth. The FHLBB issued Memorandum R-49 (R-49). This is a regulatory accounting principle (RAP). RAP must be followed in filing financial statements with the FHLBB.

R-49 provides that "a loss resulting from a difference between market value and book value in connection with reciprocal sales of substantially identical mortgage loans need not be recorded". Mortgage loans are identical only when each of the following criteria is met. The loans involved must:

- Be single-family residential mortgages.
- Be of a similar type (e.g. conventional loans for conventional loans).
- Have the same stated terms to maturity (e.g. 30 years).
- Have identical stated interest rates.
- Have similar seasoning (i.e., remaining terms to maturity).
- Have aggregate principal amounts within the lessor of 2.5% or $100,000 (plus or minus) on both sides of the transaction, with any additional consideration being paid in cash.
- Be sold without recourse.
- Have similar market values.
- Have similar loan-to-value ratios at the time of the reciprocal sale.
- Have all security properties for both sides of the transaction in the same state.

Generally accepted accounting principles provide that no gain or loss will be recognized if the first nine items listed in R-49 are present.

For tax purposes most S&Ls have deducted a loss of the difference between their basis in the mortgages given up and the fair market value of the mortgages received.

Rev. Rul. 81-204 explained the IRS position where three unrelated S&Ls exchanged mortgage pools that were substantially the same resulting in no gain or loss for book purposes. The ruling held that the transaction does not result in a loss for tax purposes, as the mortgages given up were not substantially different than the ones received. The loss was also denied, as the exchange had no purpose or utility other than anticipated tax benefits.
Rev. Rul. 85-125 involves the same type of transaction as Rev. Rul. 81-204, except that the three S&Ls entered into a series of concurrent transactions in which the mortgage pools were sold for cash and purchased by one another instead of exchanged. Again, the IRS concluded that the economic condition of the taxpayer had not changed, thus there was no tax loss.

In late 1981, the Federal Home Loan Mortgage Corporation (FHLMC) started a mortgage loan swap program in which S&Ls could enhance their liquidity position by replacing mortgage loans with guaranteed FHLMC mortgage participation certificates (PCs). These PCs were eligible collateral for borrowing. Since the PCs were backed by loans made by several lenders and not one, a gain or loss resulted for RAP purposes.

The initial program was changed to provide that the loans exchanged for PCs were economically matched resulting in no gain or loss for RAP purposes. In PLR 8327008 (1983) the IRS held that this type of transaction resulted in no gain or loss for tax purposes.


Cottage Savings Association simultaneously sold and purchased 90% participation interests in mortgage loans with other lenders. All of the loans were secured by single-family homes that for the most part were located in the same geographic area. Centennial Savings Bank exchanged 90% participation interest in a set of mortgage loans with the Federal National Mortgage Association. No gain or loss was reported for regulatory or book purposes.

For tax purposes Cottage and Centennial claimed a deduction under IRC Section 1001(a) for the difference between their basis in the participation loans given up and the fair market value of the participation loans received. The IRS disallowed the deduction, arguing that the requirements for a "disposition of property" under IRC Section 1001 were not met as the properties were not materially different and did not differ in economic substance.

The Supreme Court agreed with the IRS that an exchange of property gives rise to a realization event under IRC Section 1001(a) only if the properties exchanged are materially different, citing Treas. Reg. Section 1.1001-1. The Supreme Court then found that the properties were materially different and ruled against the IRS.

The auditor should determine how the taxpayer reported the deferred loan fees on the loans sold. For example:

Safe & Secure S&L made 10 loans of $100,000 each, three years ago. Current interest rates are much higher then when the loans were made. In connection with the loans the S&L received $60,000 in loan fees that were properly deferred. Under an acceptable method of accounting 10% of the loan principal
was paid off and 10% of the loan fees were previously included in taxable income. The fair market value of loans received in the swap was $500,000. The swap qualified for non-recognition of loss for regulatory purposes.

The taxpayer computed the tax loss as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair Market Value of Loans Received</td>
<td>500,000</td>
</tr>
<tr>
<td>Basis in Loans Exchanged ($1,000,000 x 90%)</td>
<td>-900,000</td>
</tr>
<tr>
<td>Loss on Exchange</td>
<td>-400,000</td>
</tr>
</tbody>
</table>

How did the taxpayer report the $54,000 in deferred loan fees? These amounts must be accelerated into income, as the related loans are no longer owned.

The Supreme Court did not resolve all the problems related to losses on loan swaps. For example:

- The loss was not reported for book purposes. For alternative minimum tax purposes, this will impact the BURP adjustment and the loss will increase the adjusted current earnings (ACE) adjustment. See Bank & Financial Handbook Section 0600, PREFERENCE TAX COMPUTATION AND ALTERNATIVE MINIMUM TAX (AMT), for a discussion of AMT.

- It was easy for the court to look at secured real property and determine that the loans are materially different. What about loans secured by the general assets of the corporation? What about unsecured loans? Assume two banks exchange unsecured loans made to two third world countries that are in arrears. Are the loans different?
0462 MERGER BETWEEN A STOCK SAVINGS & LOAN AND A MUTUAL SAVINGS & LOAN

In the U.S. Supreme Court case, *Harold T. Paulson vs. Commissioner* (1985) 469 U.S. 131, the court held that a merger of a stock savings & loan association into a mutual savings & loan association does not qualify as a tax-free reorganization under IRC Section 354(a)(1) and IRC Section 368(a)(1)(A). The distinction between the two associations is that in a mutual savings & loan association the passbook account holders (depositors) are owners of the association—they are contingently liable for the S&L's debts. A stock S&L has stockholders that are owners of the association. The Supreme Court held that there was "no continuity of interest" as required by IRC Section 354. The stock S&L, Commerce Savings and Loan Association was merged into Citizens Federal Savings & Loan Association. The stockholders of Commerce received CD's in exchange for their stock. The court held that the merger was in fact a sale and that the stockholders were taxable on the gain realized in the exchange. See IRC Section 331 (R&TC Section 24501). Note in the case of a FSLIC, FDIC or State Agency assisted merger the continuity of interest requirement is waived by IRC Section 368.
0464  MERGER / LIQUIDATION TAX EFFECTS

There are a variety of tax consequences that can result from a merger or liquidation. See also Bank & Financial Handbook Section 0462, MERGER BETWEEN A STOCK SAVINGS & LOAN AND A MUTUAL SAVINGS & LOAN.

- In a merger what is the proper treatment of the unamortized loan fees, etc. that are carried over to the resulting corporation? Refer to the taxpayer's private letter ruling authorizing the loan liquidation method. Normally the amount should be accelerated into income.

- In some instances you may find that the merged company has sold a large loan (GNMA/FNMA) portfolio at a substantial loss. The acquiring corporation may have entered into a simultaneous agreement to buy back this same portfolio 30-90 days after the merger. In this situation we would question substance vs. form, that the transaction lacks economic substance. We might also argue that the transaction was a sham or merely a financing arrangement. See Bank and Financial Handbook Section 0460, LOANS-LOSS ON CONCURRENT SWAP OR SALE.

- Where the sale is not followed by a repurchase agreement, you should look to the legal requirements to qualify as an S&L. The bad debt reserve balance may need to be recaptured into income if the company no longer qualifies as an S&L. See Bank & Financial Handbook Section 0418, BAD DEBT RESERVE-RESTORATION TO INCOME.

- If the S&L sells its loan portfolios (as in the case of a liquidation), they must also accelerate the reporting of the unamortized loan fees, points, odd days interest, etc. The amounts must be removed from the loan liquidation schedule and reported currently.

- Did the acquired corporation utilize the same method of accounting as the acquiring corporation?

A common problem in this area involves the takeover of an S&L that did not utilize the loan liquidation method by one that did use the method. The taxpayer cites IRC Section 381(c)(4) as authority for the use of the following method:

The acquiring S&L, using a statistical sample, re-computes the acquired S&L's income on a historical basis as if it should have been using the loan liquidation method all along. The difference (in loan fees, odd days interest, etc.) between what was actually reported using their method and what would have been reported under the loan liquidation method is used to reduce current year's income of the acquiring corporation. The figure on the return is a net figure with the actual adjustment normally found on the tax spreadsheet. There is no basis in law to allow this manipulation of income by the taxpayer. Treas. Reg. Section 1.381(c)(4)-(1)(a)(1)(ii) states that the acquiring corporation shall take into its accounts the dollar balances of those accounts of the transferor corporation representing items of income which because of

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its method of accounting were not required or permitted to be included by the transferor corporation in computing taxable income for the taxable years ending on or before the date of transfer. The taxpayer's action appears to be in direct contravention to this requirement.

Another argument that could be raised is that the taxpayer's position distorts income. That is contrary to the provisions of Treas. Reg. Section 1.381(c)(4)-1(c). By picking up the transferor's original balances from the loan portfolios and adjusting income, they are in effect adjusting the income in one year of the acquiring S&L for what they claim is an over reporting of income over multiple years by the transferor S&L.
0468  NET LOANS

A bank may loan funds to foreign persons or corporations. The foreign country will most likely treat the bank as a taxpayer subject to withholding tax.

For example a California bank may loan $1,000,000 to a Brazilian corporation with $200,000 annual loan payments. The government of Brazil may withhold 30% of the interest paid. Assuming the payment is all interest in year 1, then Brazil would have withheld $60,000. For Federal income tax purposes, the bank would have included $200,000 in gross income and either deducted foreign taxes of $60,000 or used the $60,000 as a foreign tax credit.

An audit issue arises where the bank makes a net loan and only includes the net amount in gross income. In a net loan the foreign person or corporation is responsible for the foreign income tax on the loan. Assume that in the above example the loan agreement provides for a net loan with no reduction in the loan payments. The Brazilian corporation would pay $200,000 to the domestic bank and $60,000 to the government of Brazil. The issue is how to record the above transaction for tax purposes. Many banks are recording net income of $200,000. If one discharges the tax liability of another, the taxpayer who is liable for the tax realizes additional income, Old Colony Trust v. Commissioner (1929) 279 U.S. 716.

An accrual basis taxpayer must accrue additional income for taxes, assumed by another, at the time such taxes are properly accruable and the obligation is assumed, and not at a time in the future when the assumed obligation is ultimately satisfied (Rev. Rul. 57-106 as modified by Rev. Rul. 78-258).

The position of the IRS is that:

- The income must be recorded at gross. In the above example the $60,000 income tax liability of the domestic bank paid by the Brazilian corporation on behalf of the bank would be included in gross income.

- The bank must take a deduction under IRC Section 166 for the appropriate charge to its bad debt reserve to the extent of the foreign borrower's failure to pay the foreign tax liability.

In the above example the bank would record $260,000 of gross income in year one. If Brazil asks the bank for payment of tax in year two due to the failure of the borrower to pay the tax, then in year two, the bank would take a charge to the bad debt reserve for taxes paid to Brazil.

- The taxpayer must provide the documentation required by IRC Section 905(b) and Treas. Reg. Section 1.905-2 to receive the foreign tax credit.

For California income tax purposes the bank must report the tax paid by the foreign borrower on behalf of the bank in gross income. The California Revenue and Taxation Code does not provide for a deduction for taxes measured by income. Since California taxes only income from California sources, there is no foreign tax credit.

To audit the issue, the auditor would:

- Request the loan documents for foreign borrowers to see if they have net loan provisions. If the bank has several foreign loans, it is suggested that the auditor use random sample techniques.

- If the bank has net loans, determine if the taxpayer recorded the transaction at gross or net.

- Reconcile book income to the federal 1120. Review the schedule M-1 adjustments to see if the book method and tax method of recording the foreign loan is the same.

- Adjust any net loans to gross.
0470  ODD-DAYS INTEREST

Escrow interest, also known as odd-days interest or loan in process interest, is the interest charged from the time the loan is funded to the start of the period covered by the first mortgage payment. Mortgage payments are generally made 30 days in arrears. For example, mortgage interest for the month of July is usually due August 1.

Assume a mortgage is funded on June 15. The financial institution will demand interest from the time funded until the loan is paid in full. The first mortgage payment is August 1 which is for the period of July 1-July 31. The financial institution will require at the close of escrow, an interest payment for the period of June 15-June 30. The interest for this period is odd-days interest.

In some instances, odd-days interest will be paid in cash by the borrower, although most of the time the interest is paid by deducting it from the loan proceeds. The variety of the loan documents for a typical loan make it difficult to determine if odd days interest, along with other loan fees and charges, was paid with fresh funds or financed as a part of the loan.

In 1965, most savings & loan associations asked for a change in accounting method to use the loan liquidation method as provided by Rev. Rul. 64-278. The ruling provides that loan fees or points that are paid to allow the mortgage to be made at a discounted interest rate are recognized over the life of the loan since this is an interest adjustment. Rev. Proc. 94-29 announced that Rev. Rul. 64-278 is now obsolete and allows taxpayers to use the principal-reduction method of accounting for de minimis OID.

Many savings & loan associations included odd-days interest in the amount of interest to be deferred on the loan liquidation method. The problem with including the odd-days interest in this method of income deferral is that the interest does not relate to future periods, but instead relates to the current period only.

It is FTB policy to not pursue the issue of including odd-days interest in current income under either Rev. Rul. 64-278 or Rev. Proc. 94-29.
0472 REAL ESTATE OWNED (REO OR ORE)

This section is provided for historical reference only. CCR Section 24348(b) is repealed and is not applicable for taxable years beginning on or after January 1, 2002. The use of the reserve method of accounting for bad debts by banks and savings & loans is severely limited by IRC Section 585 to "small banks" as defined in IRC Section 585(c). Financials are no longer allowed to use the reserve method of accounting for bad debts. For an explanation of the current rules regarding the deduction for bad debts for banks and savings & loans, see Bank & Financial Handbook Section 0504, PROVISION FOR BAD DEBTS—FEDERAL AND CALIFORNIA METHOD.

Real estate owned (REO) is the name commonly given to property that has been foreclosed upon by savings & loan associations. Banks typically refer to it as ORE. Often taxpayers classify all of their real estate as REO or ORE including office premises, etc. For purposes of the following discussions ORE/REO is considered to represent only foreclosed property.

Real estate owned is treated differently for savings & loan associations as compared to all other taxpayers including banks and financial corporations.

Savings & Loan Associations—R&TC Section 24348.5

No gain or loss is recognized at the date of foreclosure. Upon the sale of the foreclosed property, any deficiency between the amount realized and the adjusted basis of the property is treated as a bad debt and shall be charged to the bad debt reserve. If the amount realized is greater than the adjusted basis of the property, the gain is credited to the reserve. Such treatment is correct because foreclosed property is deemed to have taken on the characteristics of the loan for which the property was security. See also Bank & Financial Handbook Section 0476, RENTAL INCOME FROM REAL ESTATE OWNED (REO), Bank & Financial Handbook Section 0486, SALE OF REO: GAIN ON IMPROVEMENTS, and Bank & Financial Handbook Section 0488, SALE OF REO: SELLING EXPENSES.

Banks, Financials and all other Corporations—R&TC Section 24952

Gain or loss is recognized at the date of foreclosure. Losses are charged to the bad debt reserve and gains are credited to income. Fair market value at the date of foreclosure is established through a bidding process whereby the foreclosing institution must bid on the property.
0476    RENTAL INCOME FROM REAL ESTATE OWNED (REO)

This section is provided for historical reference only. CCR Section 24348(b) is repealed and is not applicable for taxable years beginning on or after January 1, 2002. The use of the reserve method of accounting for bad debts by banks and savings & loans is severely limited by IRC Section 585 to "small banks" as defined in IRC Section 585(c). Financials are no longer allowed to use the reserve method of accounting for bad debts. For an explanation of the current rules regarding the deduction for bad debts for banks and savings & loans, see Bank & Financial Handbook Section 0504, PROVISION FOR BAD DEBTS—FEDERAL AND CALIFORNIA METHOD.

IRC Section 595(a) (R&TC Section 24285.5) provides that no gain or loss shall be recognized when a savings & loan association repossesses any property that was security for the payment of any indebtedness.

IRC Section 595(b) provides that the character of the foreclosed property shall be the same as the indebtedness for which the property was security. Any amount received will be treated as a payment on the security and any loss on disposal is a bad debt.

The basis in the foreclosed property is the same as the S&L's basis in the loan securing the property plus any cost of acquisition (IRC Section 595(c)).

Congress considered the business purpose of S&Ls as making home loans and not as long-term landlords. Congress viewed the situation where an S&L repossesses a property, rents the property to third parties for a relatively short period, and disposes of the property, as one transaction.

Treas. Reg. Section 1.595-1(e) provides that the S&L is not entitled to depreciation where they repossess property and rent it, as the rental real property has the same characteristics as the mortgage, which is not subject to depreciation.

In First Federal Savings and Loan Association v. U. S. (Ct. Cl. 1981) 660 F.2d 767, the Court of Claims held that net rental income from repossessed real property was not current income. It was a payment on account of indebtedness, which reduced the outstanding loan and thus reduced the net loss on sale of the property for bad debt reserve purposes.

Treas. Reg. Section 1.595-1(e)(8) examples one and two have similar fact patterns except that in example one the thrift is accountable to the creditor for rental income on the foreclosed property and the creditor is accountable to the thrift for foreclosure related expenses based on local law. The facts in example two were changed in that neither the creditor nor the thrift is accountable to one another after foreclosure. The tax treatment of income and expenses in the examples are somewhat different. Under
California law the creditor and the thrift are not accountable to one another for the rents or expenses, thus example two applies. Mortgages are non-recourse. Foreclosure on the property is in satisfaction of the debt.

Based on the above the auditor should insure:

- That depreciation is not being taken on the repossessed property. The property has the same character as the obligation, which is not depreciable.

- The thrift must increase the basis in the loan by any real property taxes paid and other IRC Section 266 carrying charges.
0480  SALE OF ACCRUED INTEREST

Many savings & loan associations experienced net operating losses during the early 1980's. For federal purposes, prior to the Tax Reform Act of 1986, financial institutions could carryback NOLs for ten years and carry-forward the NOL for five years. A financial institution may be in a position where they will lose the benefit of the NOL carryover, i.e., the taxpayer has a small loss in 1982 and the 1977 NOL carry-forward will expire in 1982.

To take full advantage of the NOL tax benefit, the taxpayer would want to accelerate income into 1982 and push expenses from 1982 to 1983. Since most financial institutions are on the cash method of accounting for tax purposes prior to the Tax Reform Act of 1986 they can more easily move income and expenses between years.

One method used to accelerate income is to enter into an agreement to sell accrued or future interest income. A calendar year savings & loan association may agree in December 1982 to sell the first one to three months of interest income of 1983 to another financial institution. Since the savings & loan association is a cash basis taxpayer they will report the income in year 1982. This will result in more income being recognized in a loss year. They hope that 1983 will be profitable for the savings & loan.

The taxpayer may also enter into this transaction to accelerate income into a loss year, as the California Revenue and Taxation Code did not provide for a NOL carry-forward prior to income years ending before January 1, 1987, except in limited situations.

Current audit policy states that if the transaction has certain characteristics, we may hold that the transaction is really a loan and not a sale, or alternatively the purchased interest must be included in the year earned (1983) to more clearly reflect income. Note, a related issue is discussed at Bank & Financial Handbook Section 0494, STRIPPED COUPON BONDS, in connection with the allocation of the basis between the interest sold and the asset held. It is important for the auditor to follow up and increase income in the years after the sale of future interest due to the reduced basis in the loan.
0484  SALE OF LOAN PARTICIPATIONS

Some financials sell parts of their loan portfolios in exchange for participation certificates (PCs). PCs are considered a form of ownership/equity ownership in the underlying mortgage (see Rev. Rul. 84-10). Therefore exchanging direct ownership for an indirect ownership does not constitute a sale. Only when the participation certificate is ultimately sold can there be recognition of a gain or loss.

As a means to avoid this non-recognition some financials may sell their loan portfolios for PCs backed by different loan portfolios. It is important to compare the nature of these loan portfolios (interest rate, value, and net return) to the nature of the loan portfolios sold or exchanged for the PCs. If they are essentially the same you should question the deductibility of the loss. How was the loss treated for book purposes?
SALE OF REO: GAIN ON IMPROVEMENTS

This section is provided for historical reference only. CCR Section 24348(b) is repealed and is not applicable for taxable years beginning on or after January 1, 2002. The use of the reserve method of accounting for bad debts by banks and savings & loans is severely limited by IRC Section 585 to “small banks” as defined in IRC Section 585(c). Financials are no longer allowed to use the reserve method of accounting for bad debts. For an explanation of the current rules regarding the deduction for bad debts for banks and savings & loans, see Bank & Financial Handbook Section 0504, PROVISION FOR BAD DEBTS—FEDERAL AND CALIFORNIA METHOD.

Treas. Reg. Section 1.595 provides that improvements of over $3,000 to REO of savings & loan associations must be capitalized. No depreciation is allowed on these improvements. When the REO is sold, any gain realized must be allocated between the improvements and the REO. A current appraisal (at the time of sale) can be used to establish the sales price of the improvements and the REO. If that is not available, other reasonable basis may be used. The following is an example of how the computation could be made:

Savings & Loan Association A foreclosed on a vacant lot in 1985. In 1986 the S&L built a house on the lot and subsequently sold it in 1986. The selling price of the house was $100,000. The cost basis of the lot was $20,000 (basis of loan + accrued interest). The cost of the improvements were $50,000.

Based on an appraisal at the date of sale, the selling price was allocated as follows:

<table>
<thead>
<tr>
<th></th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>30,000</td>
</tr>
<tr>
<td>House</td>
<td>70,000</td>
</tr>
</tbody>
</table>

Computation: Gain on land (to be credited to the bad debt reserve)

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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales Price</td>
<td>30,000</td>
</tr>
<tr>
<td>Cost</td>
<td>20,000</td>
</tr>
<tr>
<td>Gain</td>
<td>10,000</td>
</tr>
</tbody>
</table>

Gain on Improvements (to be credited directly to income)

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales Price</td>
<td>70,000</td>
</tr>
<tr>
<td>Cost</td>
<td>50,000</td>
</tr>
<tr>
<td>Gain</td>
<td>20,000</td>
</tr>
</tbody>
</table>

Request the taxpayer to provide the work papers detailing the sales of REO during the year. Inquire as to how improvements on REO are handled and insure that any gains that result from sales are not credited to the bad debt reserve. Note that the aforementioned discussion applies only to S&Ls (gains and losses...
are recognized at foreclosure for banks and financials and gains are always credited directly to income, whether relating to improvements or ORE (REO)).
0488  SALE OF REO: SELLING EXPENSES

This section is provided for historical reference only. CCR Section 24348(b) is repealed and is not applicable for taxable years beginning on or after January 1, 2002. The use of the reserve method of accounting for bad debts by banks and savings & loans is severely limited by IRC Section 585 to "small banks" as defined in IRC Section 585(c). Financials are no longer allowed to use the reserve method of accounting for bad debts. For an explanation of the current rules regarding the deduction for bad debts for banks and savings & loans, see Bank & Financial Handbook Section 0504, PROVISION FOR BAD DEBTS—FEDERAL AND CALIFORNIA METHOD.

Under Rev. Rul. 73-116, when a savings & loan association forecloses on real estate and later sells the foreclosed property, any related expenses (real estate commissions, advertising, and related selling expenses) paid or incurred by the taxpayer cannot be deducted as ordinary and necessary business deductions. They should be charged to the bad debt reserve.

A review of the REO work papers should disclose if the selling expenses are being properly reflected in the computation of the gain or loss on the sale of REO. If not, request the taxpayer to supply the records showing the amount of selling expenses for the open tax years and disallow any expenses deducted currently as ordinary and necessary business expenses. Revise the gain or loss on sales of REO computations to reflect selling expenses attributable to REO sold.
0490  SECONDARY RESERVE TRANSFERS

All institutions insured with the Federal Savings and Loan Insurance Corporation (FSLIC) are required to make premium payments for deposit insurance. Between 1961 and 1970, insured thrifts also were required to pay the FSLIC an additional annual premium to a secondary reserve. The secondary reserve was available to the FSLIC only when the regular reserve was insufficient. In 1970 thrifts were no longer required to make payments to the secondary reserve and beginning in 1970 earnings on amounts paid into the secondary reserve were used to reduce payments to the regular reserve.

Section 404 of the National Housing Act was amended in 1973 to require the FHLB to charge part of the regular premium to the secondary reserve in certain circumstances. This may also result in a refund of cash.

Section 404 of the National Housing Act was again amended in October 1974 to provide for a cash refund of the thrift's secondary reserve during the month of May for the next ten years. The combined amount in the regular and secondary reserve must equal or exceed 1.25% of the total amount of insured accounts for all member institutions.

The refund is shown on the Annual History Statement, which together with the annual insurance premium is mailed to the thrift at the end of each calendar year. The National Housing Act provides that the Annual History Statement must separately show the amount of principal repayment and accrued interest based on the ratio of these two items in the thrift's secondary reserve immediately prior to the refund. For tax purposes the payment to the secondary reserve was treated as an asset and not deductible. Payments to the secondary reserve are a separate, distinct asset that may be transferred in consolidations or mergers and may be refunded if the thrift liquidates. Since the thrift did not have use of the interest income on amounts paid into the secondary reserve such interest was not included in the thrift's taxable income.

If an amount is transferred from the secondary reserve to the regular reserve, then the portion of the amount transferred which is interest earned on the amounts in the secondary reserve is considered includible in taxable income. The entire amount transferred is allowed as a deduction for deposit insurance.

For example, assume the thrift has an account balance of $1,000 in the secondary reserve that represents $700 principal and $300 interest earned on the principal. The FSLIC decides to refund $100 of the secondary reserve that will be used to offset the premium payment to the regular reserve. For tax purposes, the thrift will include $30 in taxable income [($300/$1,000) x $100]. The thrift will deduct $100 as an ordinary and necessary business expense.
The above method is allowable by Rev. Rul. 72-366 if the FSLIC provides the break down of principal and interest. The only other acceptable method is to allocate the transfer first to interest earned on principle and then to principle after all the interest was included in taxable income (Rev. Rul. 74-371).

Suggested audit procedures:

Request the annual history statement for the year immediately prior to your first year under audit and all years under audit. Reconcile changes in the secondary reserve between income years. This should tell you:

- The amount of transfers from the secondary reserve to pay regular deposit insurance premiums.
- The amount of the transfer that should be included as interest income.

Trace the transaction through the thrift's accounts to determine the book treatment. Finally, review the federal 1120, schedule M-1 and form 100, state adjustment section to determine the state income tax treatment.

During 1987, the FSLIC notified insured thrifts that the balance of their secondary account was being transferred to the primary account in accordance with section 404(e) of the National Housing Act. A General Accounting Office (GAO) audit report of May 1, 1987 required the FSLIC to recognize certain contingent losses. Recognition of the contingent losses caused the FSLIC liabilities to exceed assets as of December 31, 1987.

The Competitive Equity Banking Act of 1987 (CEBA), P.L. 100-86 section 307 permits an offset against future insurance premiums based on the amount of premiums transferred from the secondary reserve to the primary reserve.

Many thrift institutions deducted the amount transferred from the secondary reserve on their 1987 tax return.

The IRS in TAM 9252002 held that the interest in the secondary reserve (which was never previously included in income) must be included in the tax return that includes May 1987. The interest was paid in satisfaction of an obligation.

The thrift is then entitled to a deduction in the amount of principal and interest included in the secondary account for the tax year that includes May 1987.

Auditors should insure that thrift does not just deduct the amount in the secondary reserve and not include the interest.
The auditor should also insure that for years after 1987 that the taxpayer only deducts the cash amount paid into the deposit reserve. The thrift may deduct the gross assessment and not take into account the credit for the May 1987 transfer from the secondary account.
0492 STOCK DIVIDENDS RECEIVED FROM THE FEDERAL HOME LOAN BANK

Beginning in 1978, several Federal Home Loan Banks (FHLBs) declared stock dividends payable to their member associations. Stock dividends are normally not taxable as ordinary income, but since the FHLB stock's fair value is determined by its par value, it appears that each stockholder receives something of value upon receipt of the stock dividend. Under GAAP, the association is permitted to recognize such income in the year in which receipt of the dividend occurs. However, for tax return purposes most associations have taken the position that the stock dividend is non-taxable based on their interpretation of the criteria for non-recognition of income set forth in the Internal Revenue Code. In 1980, the IRS set forth in a technical advice memorandum its interpretation of the Code; namely, that stock dividends declared by the FHLB were fully taxable in the year received. The Service's position is based on the fact that the associations are entitled to immediately redeem the distributed stock if their holdings exceed the statutory required amount. Even though all associations are not in a similar excess holdings position, the Service concluded that, under the regulations, all associations must recognize the stock dividend as taxable income (Rev. Rul. 83-68).


The IRS acquiesced in the Tax Court holding (see 1990-1 CB 1 or AOD 1990-018). The IRS also issued Rev. Rul. 90-98 that effectively withdrew Rev. Rul. 83-68.
0494 STRIPPED COUPON BONDS

An example of this type of transaction is:

XY Corporation acquires a $1,000,000 bond for $950,000 that has detachable interest coupons. The coupons are submitted to the issuing corporation every 6 months for payment of interest.

XY Corporation then sells the bond after removing the coupons.

Assuming the bond, which is now non-interest bearing is sold for $700,000, XY Corporation takes a loss of $250,000 ($700,000 sales price less $950,000 basis) and continues to collect interest on the coupons.

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) added new provisions (now IRC Section 1286). These provisions basically require the taxpayer to include the pre-sale accrued interest in income, increase the basis of the bond by the accrued interest, and allocate the basis between the items retained and the items sold, based on fair market value of the two. These provisions covered sales made after 7/1/82.

In TAM 8827002 released 7/8/88, the IRS determined that a taxpayer must allocate their basis in a bond between the interest coupon detached and held and the principal of the note sold, according to fair market values.

The Technical Advice Memorandum involved a transaction prior to 7/1/82, thus was based on pre-TEFRA law.

The IRS cited Treas. Reg. Section 1.61-6(a) in support of the requirement that an allocation of basis between items retained and disposed of is required. The regulation covered transfers of real property. The IRS compared the bond to real property in that the detached coupon was like a remainder interest and life estate in real property. The bond principal is also similar to a remainder interest. The IRS then compared the bonds and real property in that neither produces a cost recovery deduction as land is not depreciated and bonds are not amortized.

R&TC Section 24990 incorporates by reference IRC Section 1286 for income years beginning on or after January 1, 1987. TEFRA enacted IRC Section 1232B as the proper treatment of stripped coupon bonds. The Tax Reform Act of 1986 renumbered Section 1232B as IRC Section 1286.

R&TC Section 24903 incorporated IRC Section 1232B as the California tax treatment of stripped bonds. R&TC Section 24903 was effective for income years beginning on or after January 1, 1983. R&TC Section 24903 was repealed in 1987 and R&TC Section 24990 took its place.
Some calendar year end banks or financial corporations sold stripped bonds after July 1, 1982. On their 1982 California tax return they made a state adjustment to deduct the basis of the portion of the bond retained stating that R&TC Section 24903 was not effective until the next income year. Thus, for federal purposes they applied the provisions of IRC Section 1232B to allocate basis to the portion of the bond retained and reduced the loss on sale of part of the bond. For state purposes the taxpayer is allocating 100% of the basis to the portion of the bond sold.

The rationale of the Technical Advice Memorandum can be used to conform to federal treatment for income year 1982. This issue may also overlap with sale of accrued or future interest.

Future interest was sold by numerous thrifts during 1983 – 1986. They elected out of installment sale treatment for state purposes but not for federal purposes. The state adjustment section of Form 100 would reflect this state versus federal difference. The majority of the thrifts ignored the state’s conformity to section IRC Section 1232B. The auditor should require that the proper Section 1232B adjustment be computed by the taxpayer, and determine how it impacts future income.
0500 STATE ADJUSTMENTS TO INCOME PER LINE 28 OF THE FEDERAL RETURN

For taxable years beginning on or after January 1, 2002, financials are no longer allowed to use the reserve method of accounting for bad debts. Further, the use of the reserve method of accounting for bad debts by banks and savings & loans is severely limited by IRC Section 585 to "small banks" as defined in IRC Section 585(c). Further, those banks, savings & loans, and financials required to stop using the reserve method of accounting for bad debts are required to include 50% of the bad debt reserve, as of January 1, 2002 in taxable income. The use of the reserve method of accounting for taxable years beginning on or after January 1, 2002 is described in detail in Bank & Financial Handbook Section 0504, PROVISION FOR BAD DEBTS—FEDERAL AND CALIFORNIA METHOD.

For taxable years beginning on or before December 31, 2001 (that is before January 1, 2002) there was a significant difference between federal and state taxable income as the result of the provision allowed for bad debts for banks, savings & loan associations, and financial corporations. Extensive discussion regarding the prior California law and regulations pertaining to the bad debt deduction are provided in Bank & Financial Handbook Sections 0508, 0512, 0514, 0515, 0516, 0520, 0524, 0528, 0532, 0536, 0537, 0538, 0539, 0540, and 0541 for historical reference purposes, and to assist in the audit of any taxable year beginning before January 1, 2002.
0504  PROVISION FOR BAD DEBTS—FEDERAL AND CALIFORNIA METHOD

Effective for taxable years beginning on or after January 1, 2002, California conformed to the federal bad debt deduction rules for banks, as defined in IRC Section 581. (R&TC Section 24348.) The term bank in IRC Section 585 includes savings & loan institutions. It is important to note that the federal definition of a bank in IRC Section 581 does NOT include a financial corporation. For taxable years beginning on or after 1/1/96, the federal bad debt provisions applicable to savings & loans were repealed. (IRC Section 593(f).) Effectively, this means that the rules for the deduction for bad debts that govern banks are the same as those governing savings & loan associations.
0504.1 Transition Rules For Taxable Years Beginning On Or After January 1, 2002

Large banks (institutions that have more than $500 million in assets) are not allowed to use the reserve method of accounting. (IRC Section 585(c).) Large banks, including large savings & loan associations, and all financial corporations, are limited to the specific charge-off method to determine the deduction for bad debts. The specific charge-off method limits the deduction to debts that become worthless within the taxable year. (IRC Section 166(a).)

The change required for large banks, large savings & loan associations, and all financial corporations, to the specific charge-off method of accounting for bad debts constitutes a change in method of accounting. R&TC Section 24348(c)(2)(D)(i) requires large banks, large savings & loan associations, and all financial corporations to recognize 50% of their existing bad debt reserve balances as income in the year of change, taxable year 2002. (See question AA, side 1, 2002 FTB Form 100 and schedule G, 2002 Form 100 Booklet.)

For those banks remaining on the reserve method of accounting, the prior year's ending reserve is carried over, and the reserve is computed using the federal rules contained in IRC Section 585. This means that the beginning balance in the bad debt reserve computation was computed on a California basis, using pre-conformity California rules. The history portion of the computation relating to the eligible loan base and charge offs will also be stated using pre-conformity California rules. However, the current year deduction, including loan base and charge-offs, will be computed using the federal bad debt rules under IRC Section 585.

So what are the federal bad debt rules? As stated above, large banks, large savings & loan associations, and all financial corporations with assets over $500 million are not allowed to use the reserve method of accounting. They will compute their bad debt deduction using the specific charge off method (IRC Section 166(a)). For those banks allowed to use the reserve method of accounting for bad debts for federal purposes, effective for taxable years after 1986, the only permissible method for computing the bad debt deduction under the reserve method is the "experience method". (IRC Section 585(b).)
0504.2 The Experience Method Used For Federal And California Purposes

The experience method is described at Treas. Reg. Section 1.585-2(c)(1) and allows for the use of a six-year moving average computation. To determine the addition to the reserve using the experience method the bank first calculates its loan loss experience for the current and preceding five taxable years. This is referred to as the six-year moving average. To perform this calculation, the bank sums the net charge-offs for each of the six years and divides the result by the sum of the outstanding loans at year-end for each of the six years. This determines the loss experience percentage. This percentage is multiplied by the amount of the current year's outstanding loan balance, resulting in the bank's permissible ending reserve balance.

EXAMPLE:

An example of the federal and California six-year moving average used by a bank in its 2003 computation for income and franchise tax purposes is as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Eligible Loans*</th>
<th>Net Losses At Year End (Net of Recoveries)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1998</td>
<td>$300,000</td>
<td>$4,000</td>
</tr>
<tr>
<td>1999</td>
<td>200,000</td>
<td>(3,000)</td>
</tr>
<tr>
<td>2000</td>
<td>100,000</td>
<td>5,500</td>
</tr>
<tr>
<td>2001</td>
<td>150,000</td>
<td>2,000</td>
</tr>
<tr>
<td>2002</td>
<td>200,000</td>
<td>3,500</td>
</tr>
<tr>
<td>2003</td>
<td>350,000</td>
<td>2,000</td>
</tr>
</tbody>
</table>

**Totals**

$1,300,000 $14,000

**Six-Year Moving Average:**

Bad Debt Loss Ratio: $14,000/$1,300,000 = 1.0769%

Allowable Reserve at Year End $350,000 x 1.0769% = $3,769

- Beginning Reserve before Bad Debt Provision $5,000
- Less net charge-offs in 2003 2,000
- Bad Debt Reserve before Provision 3,000
- Allowable Addition to Bad Debt Reserve 769
* Taxable Years 1998 through 2001 use the California definition of eligible loans; 2002 and 2003, use the federal definition of eligible loans.
0504.3 Eligible Loan Base

Beginning in 2002, the eligible loan base for federal and California income and franchise tax purposes includes debt, customer overdrafts, banker’s acceptances, and loan participations. (See Treas. Reg. Section 1.585-2(e)(2).) The service has ruled that mortgage-backed pass-through certificates are also loans for this purpose. (See PLR 8928002.) Beginning in 2002, the eligible loan base will be determined by reference to Treas. Reg. Section 1.585-2(e)(2) and other rulings by the IRS interpreting this regulation. Generally, the IRS has defined the eligible loan base more broadly than the FTB defined the loan base in former CCR Section 24348(b)(3).
0504.4 Exceptions To The Six-Year Rule

The IRS may allow a bank to compute its loan loss experience using fewer than six years, if the bank's activities have undergone a significant change during the six-year period. (See Treas. Reg. Section 1.585-2(c)(1)(ii).) Also see the following PLRs, allowed PLRs 8327038, 8425073, 8742038, and 8742040; not allowed PLRs 8427025 and 8924037. The FTB will follow the federal determination regarding the correct number of years used to determine loss experience, and this is not a determination where a separate state election is allowed.
0504.5 Minimum Addition To The Reserve For Bad Debts

Unlike the reserve method of accounting for bad debts previously allowed by CCR Section 24348(b)(3), the treasury regulations require a bank to make a minimum addition to its bad debt reserve each year. (See Treas. Reg. Section 1.585-2(a)(2).) For taxable years beginning after December 31, 1987, the minimum addition to the reserve for losses on loans for each taxable year is an amount equal to the amount allowable under IRC Section 585(b)(3)(A) and paragraph (c)(1)(ii) of Treas. Reg. Section 1.585-2. There currently is no IRC Section 585(b)(3)(A). However, IRC Section 585(b)(3)(A) was renumbered as Section 585(b)(2)(A) in 1990, and Section 585(b)(2)(A) describes the experience method of accounting for bad debts. Treas. Reg. Section 1.585-2(c)(1)(ii) describes the amount allowed under the experience method, the six-year moving average amount.
0504.6 Alternate Method Of Computing The Addition To The Reserve For Bad Debts

There is an alternate method for computing the addition to the bad debt reserve—the reserve balance approach. Banks are allowed to use the greater amount as the addition to the bad debt reserve. (See IRC Section 585(b)(2)(B).) Basically, if loans are greater than the base year*, the bank is allowed to add the charge-offs for the current year to the reserve for bad debts. (See IRC Section 585(b)(2)(B).)*

Example 1

In 2002, X bank (a bank allowed to use the reserve method of accounting for bad debts in accordance with IRC Section 585(c)) sustained a bad debt of $50,000. The balance in the reserve for losses on loans on December 31, 2002, was $100,000. The balance of the loans increased from $1 million in 2001 to $1.25 million in 2002. The experience method bad debt deduction under the minimum reserve level calculation is as follows:

<table>
<thead>
<tr>
<th>Balance of reserve for losses on</th>
<th>Loans at base year end (December 31, 2002)</th>
<th>$100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less: Bad debts, net of recoveries</td>
<td>(50,000)</td>
<td></td>
</tr>
<tr>
<td>Deduction based on minimum reserve level</td>
<td>$ 50,000</td>
<td></td>
</tr>
</tbody>
</table>

Example 2

Using the same facts as in example 1, except the balance of loans outstanding at the end of 2002 is $900,000. Because the balance of qualifying loans at the current year end ($900,000) is less than the balance of qualifying loans at the base year end ($1 million) the minimum reserve level that may be maintained is calculated as follows:

\[
\begin{align*}
\text{Loan reserve at base year} & \times \text{Loans outstanding at current year} \\
$100,000 & \times \$900,000 = \$90,000 \\
$1,000,000 & \times  \\
\end{align*}
\]

Based on the above facts, the deduction for the addition to the bad debt reserve is calculated as follows:

<table>
<thead>
<tr>
<th>Balance of reserve for losses on</th>
<th>Loans at base year end (December 31, 2002)</th>
<th>$90,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less: Bad debts, net of recoveries</td>
<td>(50,000)</td>
<td></td>
</tr>
<tr>
<td>Deduction based on minimum reserve level</td>
<td>$40,000</td>
<td></td>
</tr>
</tbody>
</table>
*Because the most recent adoption of the experience method for California purposes was for taxable years beginning on or after January 1, 2002, the base year for California purposes will be the last taxable year beginning before 2002.

*The reserve balance approach, IRC § 585(b)(2)(B) is the lower of—

(i) the balance of the reserve at the close of the base year, or

(ii) if the amount of loans outstanding at the close of the taxable year is less than the amount of loans outstanding at the close of the base year, the amount which bears the same ratio to loans outstanding at the close of the taxable year as the balance of the reserve at the close of the base year bears to the amount of loans outstanding at the close of the base year.
The information provided in the Franchise Tax Board’s internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.

0508 THE RESERVE METHOD FOR CALIFORNIA PURPOSES

This section is provided for historical reference only. CCR Section 24348(b) is repealed and is not applicable for taxable years beginning on or after January 1, 2002. The use of the reserve method of accounting for bad debts by banks and savings & loans is severely limited by IRC Section 585 to “small banks” as defined in IRC Section 585(c). Financials are no longer allowed to use the reserve method of accounting for bad debts. For an explanation of the current rules regarding the deduction for bad debts for banks and savings & loans, see Bank & Financial Handbook Section 0504, PROVISION FOR BAD DEBTS—FEDERAL AND CALIFORNIA METHOD.

R&TC Section 24348 provides that a deduction shall be allowed for debts becoming worthless within the income year, or, in the discretion of the Franchise Tax Board, a reasonable addition to a reserve for bad debts. In contrast to the federal government, California continues to allow the reserve method for bad debt deductions for banks, savings & loans and financial corporations.
0508.1  Financial Corporations (Other Than Banks And Savings & Loan Associations)

This section is provided for historical reference only. CCR Section 24348(b) is repealed and is not applicable for taxable years beginning on or after January 1, 2002. The use of the reserve method of accounting for bad debts by banks and savings & loans is severely limited by IRC Section 585 to "small banks" as defined in IRC Section 585(c). Financials are no longer allowed to use the reserve method of accounting for bad debts. For an explanation of the current rules regarding the deduction for bad debts for banks and savings & loans, see Bank & Financial Handbook Section 0504, PROVISION FOR BAD DEBTS—FEDERAL AND CALIFORNIA METHOD.

The reasonable reserve for bad debts for financial corporations other than banks and savings & loans is derived by use of the six year moving average. The allowable addition to the reserve is the difference between the reserve after current year's charge-offs and the reasonable reserve as calculated by multiplying the year-end receivables by the taxpayer's average loss experience of the past six years, including the current income year. This reserve computation is commonly known as the "Black Motor Car Formula". See also Bank & Financial Handbook Section 0512, THE MOVING AVERAGE COMPUTATION.

An example of the six-year moving average used by a taxpayer in its 1984 computation is as follows:

<table>
<thead>
<tr>
<th>Accounts Receivable</th>
<th>Net Losses At Year End (Net of Recoveries)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1979</td>
<td>$300,000 $4,000</td>
</tr>
<tr>
<td>1980</td>
<td>200,000 $(3,000)</td>
</tr>
<tr>
<td>1981</td>
<td>100,000 5,500</td>
</tr>
<tr>
<td>1982</td>
<td>150,000 2,000</td>
</tr>
<tr>
<td>1983</td>
<td>200,000 3,500</td>
</tr>
<tr>
<td>1984</td>
<td>350,000 2,000</td>
</tr>
<tr>
<td>Totals</td>
<td>$1,300,000 $14,000</td>
</tr>
</tbody>
</table>

Six-Year Moving Average:

Bad Debt Loss Ratio: $14,000/$1,300,000 = 1.0769%
Allowable Reserve at Year End $350,000 x 1.0769% = $3,769

| Beginning Reserve before Bad Debt Provision | $5,000 |
| Less net charge-offs in 1984            | 2,000  |

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.
<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bad Debt Reserve before Provision</td>
<td>3,000</td>
</tr>
<tr>
<td>Allowable addition to Bad Debt Reserve</td>
<td>$769</td>
</tr>
</tbody>
</table>
0508.2  Banks And Savings & Loan Associations

This section is provided for historical reference only. CCR Section 24348(b) is repealed and is not applicable for taxable years beginning on or after January 1, 2002. The use of the reserve method of accounting for bad debts by banks and savings & loans is severely limited by IRC Section 585 to "small banks" as defined in IRC Section 585(c). Financials are no longer allowed to use the reserve method of accounting for bad debts. For an explanation of the current rules regarding the deduction for bad debts for banks and savings & loans, see Bank & Financial Handbook Section 0504, PROVISION FOR BAD DEBTS—FEDERAL AND CALIFORNIA METHOD.

Bank & Financial Handbook Section 0508.21 -Years Beginning After 12/31/76 and Before 1/1/85
Bank & Financial Handbook Section 0508.22 -Years Beginning After 12/31/84
0508.21 Banks And Savings & Loan Associations—Years Beginning After 12/31/76 And Before 1/1/85

This section is provided for historical reference only. CCR Section 24348(b) is repealed and is not applicable for taxable years beginning on or after January 1, 2002. The use of the reserve method of accounting for bad debts by banks and savings & loans is severely limited by IRC Section 585 to "small banks" as defined in IRC Section 585(c). Financials are no longer allowed to use the reserve method of accounting for bad debts. For an explanation of the current rules regarding the deduction for bad debts for banks and savings & loans, see Bank & Financial Handbook Section 0504, PROVISION FOR BAD DEBTS—FEDERAL AND CALIFORNIA METHOD.

CCR Section 24348(b) effective for income years beginning after December 31, 1976 and before January 1, 1985, provides that a reasonable addition to the reserve for bad debts shall not exceed the amount necessary to increase the reserve at year-end to the greater of the following three amounts:

1) The amount that is determined by multiplying loans outstanding at the close of the income year by the ratio of (I) the total bad debts sustained during the income year and the five preceding years, adjusted for recoveries of bad debts for such period, to (II) the sum of loans outstanding at the close of such six income years. At the option of the taxpayer, in lieu of the ratio obtained by this formula, the ratio may be computed by using an average of annual averages for the six-year period (see Bank & Financial Handbook Section 0512, THE MOVING AVERAGE COMPUTATION).

2) The amount that the taxpayer establishes is reasonably necessary to absorb anticipated losses in the light of prevailing conditions relating to the taxpayer's portfolio. This is commonly known as the "out clause" or the "facts and circumstances method" (see Bank & Financial Handbook Section 0516, THE "OUT CLAUSE" OR "FACTS AND CIRCUMSTANCES METHOD").

3) The amount of the bad debt reserve determined as of December 31, 1976, provided that for income years beginning after December 31, 1978, the addition shall not exceed the amount necessary to increase the reserve to an amount that is 10 times the amount of the maximum reserve determined under (1) above.

An example of the computation for the addition to the reserve for income years beginning before January 1, 1985 (in this case 1984) follows:

<table>
<thead>
<tr>
<th>Eligible Year</th>
<th>Loan Base</th>
<th>Net Charge-Offs</th>
<th>Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>1979</td>
<td>$27,000,000</td>
<td>$184,000</td>
<td>0.6815%</td>
</tr>
<tr>
<td>1980</td>
<td>29,000,000</td>
<td>106,000</td>
<td>0.3655%</td>
</tr>
</tbody>
</table>

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.
The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.
Greater of §24348(b)(3)(A)(i),(ii) or (iii) = $142,230

[Options (1) (2), or (3)]
(a) Beginning Reserve before Bad Debt Provision $290,000
(b) Less: Net Charge-offs in 1984 179,000
  110,000  110,000
Allowable Addition to Reserve $31,230

Note that although the taxpayer had $179,000 of actual net charge-offs during 1984, they are entitled to a deduction of only $31,230 because their beginning reserve balance of $290,000 is high.
0508.22 Banks And Savings & Loan Associations—Years Beginning After 12/31/84

This section is provided for historical reference only. CCR Section 24348(b) is repealed and is not applicable for taxable years beginning on or after January 1, 2002. The use of the reserve method of accounting for bad debts by banks and savings & loans is severely limited by IRC Section 585 to "small banks" as defined in IRC Section 585(c). Financials are no longer allowed to use the reserve method of accounting for bad debts. For an explanation of the current rules regarding the deduction for bad debts for banks and savings & loans, see Bank & Financial Handbook Section 0504, PROVISION FOR BAD DEBTS—FEDERAL AND CALIFORNIA METHOD.

For income years beginning after December 31, 1984 a reasonable addition for a bank or savings & loan shall not exceed the amount necessary to increase the reserve at the close of the income year to the greater of:

(1) The amount which is determined by multiplying loans outstanding at the close of the income year by the ratio of (I) the total bad debts sustained during the income year and the five preceding years, adjusted for recoveries of bad debts for such period, to (II) the sum of loans outstanding at the close of such six income years. (At the option of the taxpayer, in lieu of the ratio obtained by this formula, the ratio may be computed by using an average of annual averages for the six-year period (see Bank & Financial Handbook Section 0512, THE MOVING AVERAGE COMPUTATION);

(2) The amount as computed in (1) above for a three-year, rather than a six-year period;

(3) For income years beginning before January 1, 1989, the amount of the bad debt reserve determined as of December 31, 1976, provided that for income years beginning after December 31, 1984, the addition shall not exceed the amount necessary to increase the reserve to an amount that is five times the amount of the maximum reserve determined under (1) above; or,

(4) The "out clause" or the "facts and circumstances method", as modified by CCR Section 24348(b), is also available if the taxpayer is able to establish that the addition to the reserve under either method (1), (2), or (3) is not sufficient to absorb anticipated losses. The taxpayer may then claim an additional amount necessary to absorb such losses provided that the amount of the reserve does not exceed the lesser of:

- The amount of the reserve required by or reported to bank or savings and loan association regulatory agencies and reflected in taxpayer's published financial statements; or,

- 1% of the amount of loans outstanding at the close of the income year.
The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.

See also Bank & Financial Handbook Section 0516, THE “OUT CLAUSE” OR “FACTS AND CIRCUMSTANCES METHOD”.

An example of the computation for the addition to the reserve for income years beginning after December 31, 1984 follows on the next page:

(Note: for illustration purposes, it is being assumed that the taxpayer used the weighted average method and the computation is for the year 1985 and the out clause option was not taken.)

<table>
<thead>
<tr>
<th>Eligible Year</th>
<th>Loan Base</th>
<th>Net Charge-Offs</th>
<th>Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>29,000,000</td>
<td>106,000</td>
<td>0.3655%</td>
</tr>
<tr>
<td>1981</td>
<td>35,000,000</td>
<td>58,000</td>
<td>-0.1657%</td>
</tr>
<tr>
<td>1982</td>
<td>43,000,000</td>
<td>82,000</td>
<td>0.1907%</td>
</tr>
<tr>
<td>1983</td>
<td>50,000,000</td>
<td>77,000</td>
<td>0.1540%</td>
</tr>
<tr>
<td>1984</td>
<td>55,000,000</td>
<td>179,000</td>
<td>0.3255%</td>
</tr>
<tr>
<td>1985</td>
<td>56,000,000</td>
<td>122,000</td>
<td>0.2179%</td>
</tr>
<tr>
<td>6 Year Totals</td>
<td>268,000,000</td>
<td>508,000</td>
<td>1.0879%</td>
</tr>
<tr>
<td>3 Year Totals</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Eligible Year</th>
<th>Loan Base</th>
<th>Net Charge-Offs</th>
<th>Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>(85-83)</td>
<td>161,000</td>
<td>378,000</td>
<td>0.6974%</td>
</tr>
</tbody>
</table>

6 Year Weighted Avg.                  3 Year Weighted Avg.
$508,000                           $378,000
Over = .1896%                      Over = .2325%
$268,000,000                               $161,000,000
6 Year Avg. of Ratios               3 Year Avg. of Ratios
.0879%                                .6974%
Over = .1813%                      Over = .2348%
6                                      3

Allowable Reserve balance:
Greater of:

(1)(a) Loans outstanding at year-end multiplied by 6 year weighted avg.
$56,000,000 x .1896% = $106,176

(b) Loans outstanding at year-end multiplied by 6 year weighted avg. of ratios
$56,000,000 x .1813% = $101,528

(2)(a) Loans outstanding at year-end multiplied by 3 year weighted avg.
$56,000,000 x .2348% = $131,488

(b) Loans outstanding at year end multiplied by 3 year $130,200
weighted avg. of ratios

(3) Limited Fill-Up Method:
Lesser of 12/31/76 Reserve 97,000; or 5 times amount computed under 6 year weighted avg.
($56,000,00 x .1896% x 5 = 530,880) $97,000

Allowable Reserve:
Greater of:
(1), (2) or (3) $131,488

Beginning Reserve before Bad Debt Provision $142,230
Less Net Charge-offs in 985 122,000
Bad Debt Reserve before Provision 20,230 20,230
Allowable Addition to Reserve $111,258
0512 THE MOVING AVERAGE COMPUTATION

This section is provided for historical reference only. CCR Section 24348(b) is repealed and is not applicable for taxable years beginning on or after January 1, 2002. The use of the reserve method of accounting for bad debts by banks and savings & loans is severely limited by IRC Section 585 to "small banks" as defined in IRC Section 585(c). Financials are no longer allowed to use the reserve method of accounting for bad debts. For an explanation of the current rules regarding the deduction for bad debts for banks and savings & loans, see Bank & Financial Handbook Section 0504, PROVISION FOR BAD DEBTS—FEDERAL AND CALIFORNIA METHOD.

The theory behind the moving average computation is that a taxpayer's past loss experience is the best guide as to what its loss experience will be in the following year. Over the years, the period of time used in the measure of the loss experience has varied from twenty years to three years. The "Black Motor Co. Formula", Black Motor Co., Inc. (1940) 41 BTA 300, approved by the U.S. Supreme Court in Thor Power Tool Co. v. Commissioner (1979) 439 U.S. 522, validated the use of the six-year moving average as an accurate measure in establishing a bad debt reserve provision. "Black Motor" is the case most frequently cited as authority for requiring the use of the six-year moving average for general and financial corporations (exclusive of banks and savings & loan associations). Banks and savings & loan associations have been considered special industries. While the theory of the moving average has been utilized, a variety of modifications have been made including, a longer or shorter time frame used in the computation of the moving average, the choice of using the "weighted averages" or the "average of the averages", reserve ceilings, etc.
0514   FINANCIAL INSTITUTIONS WITH LESS THAN 6 YEARS OF LOSS EXPERIENCE

This section is provided for historical reference only. CCR Section 24348(b) is repealed and is not applicable for taxable years beginning on or after January 1, 2002. The use of the reserve method of accounting for bad debts by banks and savings & loans is severely limited by IRC Section 585 to "small banks" as defined in IRC Section 585(c). Financials are no longer allowed to use the reserve method of accounting for bad debts. For an explanation of the current rules regarding the deduction for bad debts for banks and savings & loans, see Bank & Financial Handbook Section 0504, PROVISION FOR BAD DEBTS—FEDERAL AND CALIFORNIA METHOD.

A financial institution having less than six years of loss experience can compute its loss ratio by averaging any combination it may select of its own loss experience or the industry-wide experience for each year of the six-year period. Newly formed financial institutions may continue to use industry experience for the 6th through 10th years to the extent they are included in the six-year moving average computation. Thus, for example, a financial corporation in its 10th year must use its own loss experience for the 6th, 7th, 8th, 9th and 10th years, but may use the industry experience for the 5th year.

The option of using industry experience is only applicable to institutions using one of the six-year methods. Taxpayers must use their own experience if they chose to compute their ending balance using one of the three-year methods. Additionally, industry experience is only available for those institutions that were not in existence for the required period, regardless if they were doing business in California or not. For example, a new out of state institution must use their own experience if they were in existence for the period needed to compute the six-year average.
0514.1 Financial Institutions With Less Than 6 Years Loss Experience—The "Industry-wide" Average

This section is provided for historical reference only. CCR Section 24348(b) is repealed and is not applicable for taxable years beginning on or after January 1, 2002. The use of the reserve method of accounting for bad debts by banks and savings & loans is severely limited by IRC Section 585 to "small banks" as defined in IRC Section 585(c). Financials are no longer allowed to use the reserve method of accounting for bad debts. For an explanation of the current rules regarding the deduction for bad debts for banks and savings & loans, see Bank & Financial Handbook Section 0504, PROVISION FOR BAD DEBTS—FEDERAL AND CALIFORNIA METHOD.

For Banks: The loan loss experience for California and Hawaii banks is the "Industry-wide Average" as published by the 12th Federal Reserve District. While the District no longer publishes this average, the information is available on request. Our department obtains this information each year. See Exhibit B for the table of experiences.

For Savings & Loan Associations: The average loan loss experience for state purposes is determined by the Franchise Tax Board, based on tax return analysis. See Exhibit A for the table of experiences.
THE BEGINNING BAD DEBT RESERVE FOR EXISTING INSTITUTIONS COMING INTO CALIFORNIA FOR THE FIRST TIME

This section is provided for historical reference only. CCR Section 24348(b) is repealed and is not applicable for taxable years beginning on or after January 1, 2002. The use of the reserve method of accounting for bad debts by banks and savings & loans is severely limited by IRC Section 585 to "small banks" as defined in IRC Section 585(c). Financials are no longer allowed to use the reserve method of accounting for bad debts. For an explanation of the current rules regarding the deduction for bad debts for banks and savings & loans, see Bank & Financial Handbook Section 0504, PROVISION FOR BAD DEBTS—FEDERAL AND CALIFORNIA METHOD.

For non-California entities included for the first time in a combined report it is necessary to impute a beginning reserve equal to the amount computed under section CCR Section 24348(a)(2). This has the effect of allowing a deduction in the first year of combination an amount equal to the amount that would have been allowed if the entity had been following the California bad debt regulations all along.

The re-computation of the beginning bad debt reserve is needed to clearly reflect income including the matching principle of accounting. A proper matching of income and expense may not occur if the entity uses a zero beginning balance or the worldwide bad debt reserve.
THE "OUT CLAUSE" OR "FACTS AND CIRCUMSTANCES METHOD"

This section is provided for historical reference only. CCR Section 24348(b) is repealed and is not applicable for taxable years beginning on or after January 1, 2002. The use of the reserve method of accounting for bad debts by banks and savings & loans is severely limited by IRC Section 585 to "small banks" as defined in IRC Section 585(c). Financials are no longer allowed to use the reserve method of accounting for bad debts. For an explanation of the current rules regarding the deduction for bad debts for banks and savings & loans, see Bank & Financial Handbook Section 0504, PROVISION FOR BAD DEBTS—FEDERAL AND CALIFORNIA METHOD.

Bank & Financial Handbook Section 0516.1 – In General
Bank & Financial Handbook Section 0516.2 - Income Years Beginning After 12/31/84
0516.1  The "Out Clause" Or "Facts And Circumstances Method"—In General

This section is provided for historical reference only. CCR Section 24348(b) is repealed and is not applicable for taxable years beginning on or after January 1, 2002. The use of the reserve method of accounting for bad debts by banks and savings & loans is severely limited by IRC Section 585 to "small banks" as defined in IRC Section 585(c). Financials are no longer allowed to use the reserve method of accounting for bad debts. For an explanation of the current rules regarding the deduction for bad debts for banks and savings & loans, see Bank & Financial Handbook Section 0504, PROVISION FOR BAD DEBTS—FEDERAL AND CALIFORNIA METHOD.

In order to come under the provisions of the "out clause" or the "facts and circumstances method", the burden of proof lies exclusively with the taxpayer. The mere adoption of a book reserve amount is not sufficient to justify the allowance of the book reserve amount for tax purposes without specific documentation that the book reserve amount is necessary to absorb anticipated losses. The dollar amount of the book reserve is not important. Of greater importance are the facts used to determine the reserve. The auditor must examine the taxpayer's method of computing the reserve (examples are helpful) and the facts relied on. The facts may support use of the out clause. See Bank & Financial Handbook Section 0516, THE "OUT CLAUSE" OR "FACTS AND CIRCUMSTANCES METHOD" for a discussion on the use of the out clause for years ending after 12/31/84.

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.
0516.2 The "Out Clause" Or "Facts And Circumstances Method"—Income Years Beginning After 12/31/84

This section is provided for historical reference only. CCR Section 24348(b) is repealed and is not applicable for taxable years beginning on or after January 1, 2002. The use of the reserve method of accounting for bad debts by banks and savings & loans is severely limited by IRC Section 585 to "small banks" as defined in IRC Section 585(c). Financials are no longer allowed to use the reserve method of accounting for bad debts. For an explanation of the current rules regarding the deduction for bad debts for banks and savings & loans, see Bank & Financial Handbook Section 0504, PROVISION FOR BAD DEBTS—FEDERAL AND CALIFORNIA METHOD.

Effective for years after 1984, the following additional requirements were enacted through CCR Section 24348(b) pertaining to the use of the out clause:

In no event, may the resulting amount in the bad debt reserve balance after the provision made under the out clause option exceed the lesser of:

(a) The reserve balance reported to regulatory agencies and reflected in the taxpayer's published financial statements, or,

(b) 1% percent of the amount of loans outstanding at the close of the income year.
0516.21  Circumstances Required To Establish Use Of The "Out Clause"

This section is provided for historical reference only. CCR Section 24348(b) is repealed and is not applicable for taxable years beginning on or after January 1, 2002. The use of the reserve method of accounting for bad debts by banks and savings & loans is severely limited by IRC Section 585 to "small banks" as defined in IRC Section 585(c). Financials are no longer allowed to use the reserve method of accounting for bad debts. For an explanation of the current rules regarding the deduction for bad debts for banks and savings & loans, see Bank & Financial Handbook Section 0504, PROVISION FOR BAD DEBTS—FEDERAL AND CALIFORNIA METHOD.

A review of the credit worthiness of each of the following:

(1) The bank's or savings & loan association's largest loans not to represent less than 10% of its total loan portfolio, on an individual basis.

(2) A random selection of a reasonable percentage, not to be less than 5% of a particular class or classes of loans, such class or classes of loans to represent at least 50% of its remaining loan portfolio.

(3) The historic loan loss experience of the remaining loans (six-year moving average) without consideration given to the specific loans, class, or classes of loans for which a specific or sampling review was made, pursuant to (1) and (2) above.

Your review of provisions deducted under the out clause should require a strict adherence to the regulation.
0520   ELIGIBLE LOAN BASE

This section is provided for historical reference only. CCR Section 24348(b) is repealed and is not applicable for taxable years beginning on or after January 1, 2002. The use of the reserve method of accounting for bad debts by banks and savings & loans is severely limited by IRC Section 585 to "small banks" as defined in IRC Section 585(c). Financials are no longer allowed to use the reserve method of accounting for bad debts. For an explanation of the current rules regarding the deduction for bad debts for banks and savings & loans, see Bank & Financial Handbook Section 0504, PROVISION FOR BAD DEBTS—FEDERAL AND CALIFORNIA METHOD.

Bank & Financial Handbook Section 0520.1 – In General
Bank & Financial Handbook Section 0520.2 – Financial Corporations
Bank & Financial Handbook Section 0520.3 – Banks
Bank & Financial Handbook Section 0520.4 – Savings and Loans Associations
Bank & Financial Handbook Section 0520.5 – Mortgage-Backed Securities
0520.1 Eligible Loan Base - In General

This section is provided for historical reference only. CCR Section 24348(b) is repealed and is not applicable for taxable years beginning on or after January 1, 2002. The use of the reserve method of accounting for bad debts by banks and savings & loans is severely limited by IRC Section 585 to "small banks" as defined in IRC Section 585(c). Financials are no longer allowed to use the reserve method of accounting for bad debts. For an explanation of the current rules regarding the deduction for bad debts for banks and savings & loans, see Bank & Financial Handbook Section 0504, PROVISION FOR BAD DEBTS—FEDERAL AND CALIFORNIA METHOD.

The eligible loan base is to represent only loans at risk. While, generally, the state relies on federal revenue rulings as a basis for determining the portion of loans not at risk, you should not use the eligible loan base for federal purposes as a substitute for the state loan base. There are differences between the two.

The auditor must be aware that California never adopted IRC Section 585 or IRC Section 593. These sections provide specific rules to determine the addition to the reserve for banks and savings & loan associations.

R&TC Section 24348 is the equivalent of IRC Section 166. The reserve for bad debts may only reflect an amount that the taxpayer can reasonably expect to go bad. It is not reasonable to reserve for a loss when there is no risk of loss. Likewise, it is not reasonable to reserve for a loss that is unusual or infrequent. Such losses should be deducted through a specific write off.
0520.2 Eligible Loan Base - Financial Corporations

This section is provided for historical reference only. CCR Section 24348(b) is repealed and is not applicable for taxable years beginning on or after January 1, 2002. The use of the reserve method of accounting for bad debts by banks and savings & loans is severely limited by IRC Section 585 to "small banks" as defined in IRC Section 585(c). Financials are no longer allowed to use the reserve method of accounting for bad debts. For an explanation of the current rules regarding the deduction for bad debts for banks and savings & loans, see Bank & Financial Handbook Section 0504, PROVISION FOR BAD DEBTS—FEDERAL AND CALIFORNIA METHOD.

The eligible loan base includes all loans outstanding. Loans outstanding exclude loans written off in the current or previous periods, unless such write offs have been restored to the balance in the bad debt reserve.

The eligible loan base must exclude the insured or guaranteed portion of any loans. See Bank & Financial Handbook Section 0520.3, ELIGIBLE LOAN BASE—Banks, for a more in depth discussion of insured or guaranteed loans.
0520.3 Eligible Loan Base - Banks

This section is provided for historical reference only. CCR Section 24348(b) is repealed and is not applicable for taxable years beginning on or after January 1, 2002. The use of the reserve method of accounting for bad debts by banks and savings & loans is severely limited by IRC Section 585 to "small banks" as defined in IRC Section 585(c). Financials are no longer allowed to use the reserve method of accounting for bad debts. For an explanation of the current rules regarding the deduction for bad debts for banks and savings & loans, see Bank & Financial Handbook Section 0504, PROVISION FOR BAD DEBTS—FEDERAL AND CALIFORNIA METHOD.

The eligible loan base includes all loans outstanding. Loans outstanding exclude loans written off in the current or previous periods, unless such write offs have been restored to the balance in the bad debt reserve. The eligible loan base must exclude the insured or guaranteed portion of any loans. The reason for the exclusion is to eliminate, from the loan base, any loans (or portion of the loans) in which the taxpayer has no risk of loss.

CCR Section 24348(b)(3)(G) does not specifically address all items to be eliminated from the loan base. But it does state that "in computing the amount of loans outstanding at the end of the current year or any of the preceding five years, government insured loans shall be excluded to the extent they are insured or guaranteed. If the lending bank or savings & loan association has control over the withdrawal of deposits in the lending bank or savings & loan association or another bank or savings & loan association, loans secured by those deposits are to be eliminated in computing the outstanding loans. If the outstanding loans account of a bank or savings & loan association includes unearned interest or discount attributable to discounted loans, the amount of such unearned interest or discount shall be eliminated from the eligible loan base in computing outstanding loans".

The auditor may look to federal guidelines in this area, specifically Rev. Rul. 65-92, 68-630 and Treas. Reg. Section 1.585 in order to find information to judge risk.

Those two revenue rulings make note that the following items shall be eliminated from total loans to arrive at the eligible loan base:

- Government insured or guaranteed loans to the extent insured or guaranteed.
- Inter-bank deposits and loans.
- "Hold back" accounts relating to installment loans.
- Loans secured by passbooks, certificates of deposit, or other similar instruments.
• Unearned discount.

For state purposes, then, based on federal guidelines and Franchise Tax Board audit policy, items to be eliminated from the total loans to arrive at the eligible loan base include:

• Government insured or guaranteed loans to the extent so insured or guaranteed. Federal Housing Authority (FHA) Title I loans are insured up to 90% of the outstanding loan balance, FHA Title II loans are insured up to 100% and Veterans Administration (VA) loans are insured up to 60% of the loan balance outstanding.

• Unearned discounts on installment loans.

• Dealer's reserves and dealer's holdbacks.

• Advances to other departments of the bank.

• Loans secured by the borrower's deposits with the bank.

• Loans in process.

• Loans to other banks from which money is also borrowed.

• The other participant's interest in a participation loan.

• Loans to a government or political subdivision.

• Other investments in portfolios not in the nature of loans.

• Deferred loan fees.

• Any other outstanding loans for which the financial entity has no risk of loss because of guarantees or outside insurance.

• Federal funds sold.

• Certificates of deposit (CDs).
0520.4 Eligible Loan Base—Savings & Loan Associations

This section is provided for historical reference only. CCR Section 24348(b) is repealed and is not applicable for taxable years beginning on or after January 1, 2002. The use of the reserve method of accounting for bad debts by banks and savings & loans is severely limited by IRC Section 585 to "small banks" as defined in IRC Section 585(c). Financials are no longer allowed to use the reserve method of accounting for bad debts. For an explanation of the current rules regarding the deduction for bad debts for banks and savings & loans, see Bank & Financial Handbook Section 0504, PROVISION FOR BAD DEBTS—FEDERAL AND CALIFORNIA METHOD.

Items excluded from the eligible loan base are essentially identical to those noted above for banks, see Bank & Financial Handbook Section 0520.3, ELIGIBLE LOAN BASE—Banks.

Unlike banks and financial corporations, savings & loan associations must include in their eligible loan base foreclosed property. This difference is due to the fact that savings & loan associations do not recognize gain or loss at the date of foreclosure, but at the date of disposal of the foreclosed property. The foreclosed property (commonly referred to as REO (Real Estate Owned)) is deemed to represent the loan.
0520.5 Eligible Loan Base—Mortgage-Backed Securities

This section is provided for historical reference only. CCR Section 24348(b) is repealed and is not applicable for taxable years beginning on or after January 1, 2002. The use of the reserve method of accounting for bad debts by banks and savings & loans is severely limited by IRC Section 585 to "small banks" as defined in IRC Section 585(c). Financials are no longer allowed to use the reserve method of accounting for bad debts. For an explanation of the current rules regarding the deduction for bad debts for banks and savings & loans, see Bank & Financial Handbook Section 0504, PROVISION FOR BAD DEBTS—FEDERAL AND CALIFORNIA METHOD.

In the mortgage market, when lenders originate loans secured by real estate they either retain the loans in their own portfolios or sell them to investors. The selling of the loans to new investors constitutes the secondary mortgage market. Within the secondary mortgage market, two types of activities take place—the buying and selling of individual mortgages and the formation of a pool of mortgage loans resulting in the issuance of a covering security.

There are two types of covering securities, known as mortgage-backed securities (MBSs):

1. A pass-through certificate, which is a certificate evidencing the ownership of an interest in a pool of mortgage loans.

   The pass-through MBS certificates are usually issued through a grantor trust. The buyer of an MBS is not treated as a creditor, but as an owner of an undivided interest in the assets of the grantor trust. The ownership interest includes the pool proceeds, mortgaged property acquired through foreclosure that has not been withdrawn from the pool, and the issuer’s obligation to supplement the mortgage pool proceeds. A pass-through MBS provides for monthly payments of principal and interest due on the pool, less a servicing fee (usually paid to the lenders) and the issuer’s fee (guarantee fee).

2. An obligation secured by a pool of mortgage loans.

   Obligations secured by a pool of mortgage loans are debt instruments (e.g., mortgage-backed bonds). The bond was designed for the lenders to leverage the mortgage loans in their portfolios without selling assets. It is similar to bonds issued by corporations. It represents a credit instrument of the issuer. The issuer of a mortgage-backed bond retains the cash flow of the underlying mortgages. If a bond defaults, the bondholder’s trustee sells the collateral and uses the proceeds to redeem the outstanding bonds. The
most common bonds are collateralized mortgage obligations (CMOs) and obligations issued by builders (builder bonds).

In the secondary market, the MBSs are usually issued and guaranteed by FNMA (Fannie Mae), GNMA (Ginnie Mae) and FHLMC (Freddie Mac). Under the guarantor program of these quasi-governmental agencies, a lender may sell the pool of mortgages on a “recourse” or “non-recourse” basis. On a recourse basis, if the borrower defaults and foreclosure occurs, the lender is required to repurchase the mortgage from the agency and substitute a new comparable mortgage to that pool to maintain the same yield on that MBS. On non-recourse pools, the lenders are not liable for any defaults and the agency will be liable for the default.

**Federal Treatment**

The Internal Revenue Service has ruled in a technical advice memorandum (PLR 9423002) that MBSs are properly included in “loans outstanding.” The Service stated that even though MBSs are guaranteed or insured by FNMA, GNMA, or FHLMC, the certificates of participation in the mortgage pool represent a proportional ownership of the underlying mortgage. As such, holding (13) of Rev. Rul. 84-10, 1984-1 C.B. 155, supports inclusion of such certificates in the holder’s loan base. These certificates are insured by FNMA, GNMA, or FHLMC. But this does not remove them from the definition of the term “loan”. The service concluded that the MBSs should be included in the lender’s loans outstanding for purposes of the bad debt reserve computation.

**California Treatment**

In general, the eligible loan base is to represent only loans at risk. While we can rely on federal revenue rulings as a basis for determining the portion of loans not at risk, we should not use the eligible loan base for federal purposes as a substitute for the state loan base. California never adopted IRC Sections 585 or 593. These sections provide specific rules to determine the addition to the reserve for banks and savings & loan associations. R&TC Section 24348 is the equivalent of IRC Section 66. The reserve for bad debts may only reflect an amount that the taxpayer can reasonably expect to go bad. It is not reasonable to reserve for a loss when there is no risk of loss. Likewise, it is not reasonable to reserve for a loss that is unusual or infrequent. Such losses should be deducted through a specific write-off. The eligible loan base must exclude the insured or guaranteed portion of any loans.

CCR Section 24348(b)(3)(G) does not specifically address all items to be eliminated from the loan base. But states that “in computing the amount of loans outstanding at the end of the current year or any of the preceding five years, government insured loans shall be excluded to the extent they are insured or guaranteed.”

We may look to federal guidelines in this area, specifically Rev. Rul. 65-92, 68-630 and Treas. Reg. Section 1.585 in order to find information to judge risk.
Those two revenue rulings make note that the following items will be eliminated from total loans to arrive at the eligible loan base:

1. Government insured or guaranteed loans to the extent insured or guaranteed
2. Inter-bank deposits and loans
3. “Hold back” accounts relating to installment loans
4. Loans secured by passbooks, certificates of deposit or other similar instruments
5. Unearned discount

Audit Applications

Situation #1
Fact: The taxpayer did not originate or package the MBS. The taxpayer purchased the MBS from an organized market or from a broker.

Conclusion: In this situation, the owner of the MBS is an investor not a lender and the MBS should not be included in the eligible loan base. As a buyer of the instrument, the taxpayer is not subject to the same type of risk as a mortgage lender. The agency acts as the pool trustee. Depending on the agreements, either the issuer or the agency will collect and distribute principal and interest to the certificate holder or its assignee. The agency guarantees that the certificate holder will receive timely payments. Therefore, we do not consider a MBS purchased by the taxpayer as loans outstanding.

Situation #2
Fact: The taxpayer (an approved seller) assembles loans from its portfolio (could be loans originated or purchased) and sells them to FHLMC or FNMA. The purchaser (FHLMC or FNMA) forms pools of mortgages and transfers them to its MBS program and issues MBSs on the underlying mortgages. The mortgages transferred are non-recourse.

Conclusion: The MBSs should be excluded from the loan base since the MBSs sold are non-recourse. The lender is not subject to the risk of default by the borrower. In this instance, a taxable event took place. The taxpayer sold the mortgages. Usually, the lender in this type of transaction retains the servicing rights to the loans. The servicing income thus derived does not change the above conclusion.

Situation #3
Fact: Under another method of pool formation, a lender assembles a pool of mortgages from its own portfolio (originated by the lender) and transfers the loans to a grantor trust. In the industry, this transaction is usually referred to as securitization of the mortgage. In return for the mortgages transferred into the grantor trust, the lender receives an MBS certificate that it may retain or sell to investors. Frequently, MBSs are insured by GNMA, FNMA, or FHLMC in order to make them attractive to buyers. However, there is usually a recourse agreement on the underlying mortgages even though the MBS is insured by these agencies. If a mortgage is in default or there is a foreclosure, the lender is...
required to replace the defaulted mortgage with other mortgages. Depending on the pooling agreement, the lender may be at risk up to 10% of the total value of the mortgages transferred to the trust and an insuring agency may guarantee the remaining portion in excess of 10% of the total.

**Conclusion:** When a MBS is retained by the lender, the entire underlying mortgage pool should be included in the loan base for the computation of the experience ratio, but the allowable reserve will be limited to the extent of the uninsured portion. The reason is that each mortgage in the pool is still subject to the same risk of default as the other mortgage that is not packaged into a pool. The agency, GNMA, FNMA, or FHLMC serves only as the trustee of each pool and the MBS is not recorded on its books as assets or liabilities. The agency guarantees timely payments to investors of principal and interest on the mortgage loans in the pool, even if the agency (trustee) has not received payments. The securitization process enables the agency to further its statutory purpose of increasing the liquidity of the residential mortgage loans and at the same time creates a source of guaranty fee income to the agency without requiring the agency take the debt to purchase the underlying pooled mortgage loans. The only audit issue is to ascertain that the MBS and the underlying pool of mortgages is not included in the loan base twice. Theoretically, we could require the lender to segregate the loans transferred into the pool and limit the loss provision based on experience, to a maximum amount of 10% of the total value of the pool.

Example:
Out of its $4 billion total loan portfolio, lender X transferred a pool of mortgage loans in the amount of $250 million into a trust where GNMA acted as the trustee and provided a guarantee up to 90% of the total amount of the pool. In return, X received MBSs for the same value of the pool.

With the entire $250 million mortgage pool being included in the $4 billion loan base,

I. Assuming the maximum loss experience ratio derived under CCR §24348(b)(3) is 0.8%, the reserve of $32 million ($4 billion x 0.8%) is allowable. The $2 million reserve with respect to the MBSs ($250 million x 0.8%) does not exceed $25 million, the uninsured portion of the pool ($250 million x 10%).

II. Assuming the maximum loss experience ratio derived under CCR §24348(b)(3) is 16%, the reserve will be limited to $625 million [$640 – (250 x 16% - 25)].

In any event, the MBS portion of the reserve should be traced to assure the accumulated provisions do not exceed the uninsured amount.

If the lender later sells the MBS, then the ownership changes. The underlying mortgage pool of loans should be eliminated from the lender’s loan base. The MBS is evidence of a fractional undivided interest in a pool of mortgage loans. The buyer is now considered the owner of the underlying mortgage pool of loans. However, we may allow the lender to deduct losses when the lender has to supplement the pool
with a new mortgage due to the recourse agreement. The tax loss will be recognized (specific write-off) when the underlying mortgage is foreclosed.

We should be aware that the above examples are not all inclusive. We suggest audit examine the MBS agreements closely and determine whether the above examples apply to our situation.
0524  FORECLOSURES AND FORECLOSED PROPERTY

This section is provided for historical reference only. CCR Section 24348(b) is repealed and is not applicable for taxable years beginning on or after January 1, 2002. The use of the reserve method of accounting for bad debts by banks and savings & loans is severely limited by IRC Section 585 to "small banks" as defined in IRC Section 585(c). Financials are no longer allowed to use the reserve method of accounting for bad debts. For an explanation of the current rules regarding the deduction for bad debts for banks and savings & loans, see Bank & Financial Handbook section 0504, PROVISION FOR BAD DEBTS—FEDERAL AND CALIFORNIA METHOD.

Different rules apply for the recognition of gain or loss of foreclosed real estate depending upon whether the taxpayer is a bank, savings & loan, or a financial corporation other than a bank or savings & loan.
0524.1 Foreclosures And Foreclosed Property—Banks And Financial Corporations

This section is provided for historical reference only. CCR Section 24348(b) is repealed and is not applicable for taxable years beginning on or after January 1, 2002. The use of the reserve method of accounting for bad debts by banks and savings & loans is severely limited by IRC Section 585 to "small banks" as defined in IRC Section 585(c). Financials are no longer allowed to use the reserve method of accounting for bad debts. For an explanation of the current rules regarding the deduction for bad debts for banks and savings & loans, see Bank & Financial Handbook Section 0504, PROVISION FOR BAD DEBTS—FEDERAL AND CALIFORNIA METHOD.

Banks and other financial corporations, exclusive of savings & loans, recognize gain or loss at the date of foreclosure. Loss is charged to the bad debt reserve and gain is recognized as ordinary income. Upon the sale of the foreclosed property, additional gain or loss is recognized as income in the year of sale. Gain or loss at the date of foreclosure is the difference between the "bid price" of the property and the taxpayer's basis in the property. In most cases, foreclosure proceedings require that the bank or financial submit a bid for the property. In cases where there is no bidding process, "fair market value" may be established by appraisal.

Examples of a foreclosure on a parcel of real estate by a bank:

- **Gain on Foreclosure**
  
  In 1974, Safe and Secure Bank foreclosed on a parcel of real estate with a loan balance outstanding of $30,000. On the date of foreclosure, the fair market value of the foreclosed real estate was $50,000. The bank shall recognize a gain of $20,000 at the time of foreclosure and report it as taxable income for 1974. In 1977, the bank sold the real estate for a price of $60,000; the additional gain of $10,000 is taxable income in 1977.

- **Loss on Foreclosure**
  
  In 1974, Safe and Secure Bank foreclosed on a parcel of real estate with a loan balance outstanding of $30,000. On the date of foreclosure, the fair market value of the foreclosed real estate was $20,000. The Bank may charge-off to its bad debt reserve the loss of $10,000 in 1974. In 1977, the bank sold the real estate for a price of $60,000; the gain of $40,000 is taxable income in 1977.
There are other issues that can effect the computation of gain or loss on foreclosure. Refer to Bank & Financial Handbook Section 0412.1, ACCRUED INTEREST TO DATE OF FORECLOSURE; Bank & Financial Handbook Section 0472, REAL ESTATE OWNED; Bank & Financial Handbook Section 0476, RENTAL INCOME FROM REAL ESTATE OWNED; Bank & Financial Handbook Section 0486, SALE OF REO: GAIN ON IMPROVEMENTS; and Bank & Financial Handbook Section 0488, SALE OF REO: SELLING EXPENSES, for additional information.
0524.2  Foreclosures And Foreclosed Property—Savings & Loan Associations

This section is provided for historical reference only.  CCR Section 24348(b) is repealed and is not applicable for taxable years beginning on or after January 1, 2002.  The use of the reserve method of accounting for bad debts by banks and savings & loans is severely limited by IRC Section 585 to "small banks" as defined in IRC Section 585(c).  Financials are no longer allowed to use the reserve method of accounting for bad debts.  For an explanation of the current rules regarding the deduction for bad debts for banks and savings & loans, see Bank & Financial Handbook Section 0504, PROVISION FOR BAD DEBTS—FEDERAL AND CALIFORNIA METHOD.

For years after December 31, 1967, no gain or loss is recognized at the time of foreclosure. Upon subsequent sale of the property, any deficiency between the amount realized and the adjusted basis is treated as a bad debt and is charged to the bad debt reserve. If the amount realized is greater than the adjusted basis of the property, the gain is credited to the reserve. If the association is on the specific charge-off method, gain or loss upon sale is reflected in taxable income.

An example of a foreclosure on a parcel of real estate by a savings & loan association after 12/31/67 follows:

In 1973, Friendly Savings & Loan Association foreclosed on a parcel of real estate with a loan balance outstanding of $30,000. No gain or loss is recognized on the date of foreclosure. The property is subsequently sold in 1976 for $50,000. The gain of $20,000 is credited to the bad debt reserve in 1976.

There are other issues that can effect the computation of gain or loss on foreclosure. Refer to the following:

- Bank & Financial Handbook Section 0412.3, ACCRUED INTEREST TO DATE OF FORECLOSURE
- Bank & Financial Handbook Section 0472, REAL ESTATE OWNED
- Bank & Financial Handbook Section 0476, RENTAL INCOME FROM REAL ESTATE OWNED
- Bank & Financial Handbook Section 0486, SALE OF REO:  GAIN ON IMPROVEMENTS
- Bank & Financial Handbook Section 0488, SALE OF REO: SELLING EXPENSES
- Bank & Financial Handbook Section 0524.2, FORECLOSURES AND FORECLOSED PROPERTY—SAVINGS & LOAN ASSOCIATIONS.

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.
0528  RETROACTIVE ADDITIONS TO THE BAD DEBT RESERVE

This section is provided for historical reference only. CCR Section 24348(b) is repealed and is not applicable for taxable years beginning on or after January 1, 2002. The use of the reserve method of accounting for bad debts by banks and savings & loans is severely limited by IRC Section 585 to "small banks" as defined in IRC Section 585(c). Financials are no longer allowed to use the reserve method of accounting for bad debts. For an explanation of the current rules regarding the deduction for bad debts for banks and savings & loans, see Bank & Financial Handbook Section 0504, PROVISION FOR BAD DEBTS—FEDERAL AND CALIFORNIA METHOD.

A taxpayer may not claim a retroactive addition to the reserve (i.e., an addition to the reserve after the original filing of the tax return) for bad debts above the amount of bad debt deduction claimed on the taxpayer's books. See the Appeal of Culver Federal Savings and Loan Association, decided by the Board of Equalization on February 14, 1966 and Legal Ruling 417, approved March 19, 1981 for additional guidance.

Legal Ruling 417 states in part "(the ruling) is not meant to apply for a year in which additional assessments have been proposed, or for any year not barred by the statute of limitations where the association's loan loss ratio is revised by this department." Some auditors have interpreted this to mean that if we make any adjustment to income, the reserve may be changed outside the limits of Culver Federal Savings and Loan. Other auditors have limited the application of Culver Federal Savings and Loan only to situations where adjustments to the bad debt reserve were proposed.

We asked for clarification from the Legal Division. The reply was that retroactive changes to the reserve in excess of the book provisions are only allowable if the FTB has initiated changes to the reserve. This may result from current year's adjustments or prior year's adjustments that change the current year's beginning reserve.

Retroactive additions to the bad debt provision are allowed to correct math errors made in the computation of the reserve. Also see Bank & Financial Handbook Section 0538, ADDITIONAL DEDUCTION DUE TO FRANCHISE TAX BOARD AUDIT.
This section is provided for historical reference only. CCR Section 24348(b) is repealed and is not applicable for taxable years beginning on or after January 1, 2002. The use of the reserve method of accounting for bad debts by banks and savings & loans is severely limited by IRC Section 585 to "small banks" as defined in IRC Section 585(c). Financials are no longer allowed to use the reserve method of accounting for bad debts. For an explanation of the current rules regarding the deduction for bad debts for banks and savings & loans, see Bank & Financial Handbook Section 0504, PROVISION FOR BAD DEBTS—FEDERAL AND CALIFORNIA METHOD.

A negative bad debt reserve balance may not be carried over from one income year to the next since this in essence would be a form of net operating loss carryover. See Appeal of San Fernando Valley Federal Savings and Loan, decided by the Board of Equalization on March 18, 1975.
0536 MANDATORY PROVISION TO THE BAD DEBT RESERVE

This section is provided for historical reference only. CCR Section 24348(b) is repealed and is not applicable for taxable years beginning on or after January 1, 2002. The use of the reserve method of accounting for bad debts by banks and savings & loans is severely limited by IRC Section 585 to "small banks" as defined in IRC Section 585(c). Financials are no longer allowed to use the reserve method of accounting for bad debts. For an explanation of the current rules regarding the deduction for bad debts for banks and savings & loans, see Bank & Financial Handbook Section 0504, PROVISION FOR BAD DEBTS—FEDERAL AND CALIFORNIA METHOD.

Proposed Treas. Reg. Section 1.593-2 requires S&Ls to add a minimum amount to the reserve each year. This rule will come into force for taxable years beginning 60 days after the proposed regulation goes final. Proposed Treas. Reg. Section 1.593.2 has not gone final.

Rev. Rul. 79-88 requires that the taxpayer use a consistent accounting method to clearly reflect income. It is our understanding that the IRS has never applied Rev. Rul. 79-88 to banks or savings & loans.

Historically, the Franchise Tax Board has not applied Rev. Rul. 79-88 to force the taxpayer to make a provision for bad debts. However, the taxpayer must charge off receivables in the year that they are determined to be bad and accordingly reduce the bad debt reserve.

CCR Section 24348(b) acts as a ceiling as to the maximum amount of the ending reserve balance. The regulation does not provide for a minimum reserve. Of course, the taxpayer must maintain a reserve of zero or greater. A negative reserve for bad debts is not reasonable.
0537 RECOVERY OF RESERVE IN A LOSS YEAR

This section is provided for historical reference only. CCR Section 24348(b) is repealed and is not applicable for taxable years beginning on or after January 1, 2002. The use of the reserve method of accounting for bad debts by banks and savings & loans is severely limited by IRC Section 585 to "small banks" as defined in IRC Section 585(c). Financials are no longer allowed to use the reserve method of accounting for bad debts. For an explanation of the current rules regarding the deduction for bad debts for banks and savings & loans, see Bank & Financial Handbook Section 0504, PROVISION FOR BAD DEBTS—FEDERAL AND CALIFORNIA METHOD.

See Bank & Financial Handbook Section 0418, BAD DEBT RESERVE—RESTORATION TO INCOME.
0538  ADDITIONAL DEDUCTION DUE TO FRANCHISE TAX BOARD AUDIT

This section is provided for historical reference only. CCR Section 24348(b) is repealed and is not applicable for taxable years beginning on or after January 1, 2002. The use of the reserve method of accounting for bad debts by banks and savings & loans is severely limited by IRC Section 585 to "small banks" as defined in IRC Section 585(c). Financials are no longer allowed to use the reserve method of accounting for bad debts. For an explanation of the current rules regarding the deduction for bad debts for banks and savings & loans, see Bank & Financial Handbook Section 0504, PROVISION FOR BAD DEBTS—FEDERAL AND CALIFORNIA METHOD

A situation may arise where the taxpayer does not substantiate the out clause that may result in additional deductions for the taxpayer during the audit cycle. For example, assume we are auditing 1983 - 1985. The taxpayer used the out clause for 1983 and 1985 but could not substantiate the amount. We reduce the reserve based on a six-year average.

The 3-year average for 1985 results in a larger reserve than the book reserve. The taxpayer is entitled to a larger deduction in 1985 due to the lower 1985 beginning reserve from prior years audit adjustments and use of the three-year average. The auditor must allow the additional deduction in 1985. Legal Ruling 417 (referred to in Bank & Financial Handbook Section 0528, RETROACTIVE ADDITIONS TO THE BAD DEBT RESERVE) does not apply.
0539  CORRECT YEAR OF LOAN CHARGE OFF

This section is provided for historical reference only. CCR Section 24348(b) is repealed and is not applicable for taxable years beginning on or after January 1, 2002. The use of the reserve method of accounting for bad debts by banks and savings & loans is severely limited by IRC Section 585 to "small banks" as defined in IRC Section 585(c). Financials are no longer allowed to use the reserve method of accounting for bad debts. For an explanation of the current rules regarding the deduction for bad debts for banks and savings & loans, see Bank & Financial Handbook section 0504, PROVISION FOR BAD DEBTS—FEDERAL AND CALIFORNIA METHOD.

Treas. Reg. Section 1.166-2(d)(1) and Rev. Rul. 79-214 provide for the conclusive presumption of worthlessness where the bank or savings & loan association charges off a loan pursuant to an order from a regulatory agency. The regulatory agency must be the institution's federal regulatory agency, or a state authority maintaining substantially equivalent standards. The order must be in writing.

The presumption only applies to a year in which the regulatory agency tells the institution to charge off the debt, and the institution writes off the loan in the same year. The amount is limited to the amount actually charged or written off on the institution's books. For example:

- The bank's regulatory agency tells the bank to write off $1,000 of a loan to customer A in year one. The bank does not write off the loan until year two on their books of account. The conclusive presumption does not apply.

- The bank's regulatory agency tells the bank to write off $1000 of a loan to customer A in year one. The bank writes off $800 in year one on its books of account. The conclusive presumption applies to the $800.

The correctness of all other charge offs is based on facts and circumstances. The auditor should compare the charge offs for book purposes with the charge offs per tax return. Generally, the facts that support the book charge offs should support the tax charge offs. Material differences between book and tax charge offs should be investigated.
0540  MERGERS—EFFECT ON THE BAD DEBT PROVISION / RESERVE COMPUTATION

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When banks or savings & loan associations are party to a merger/consolidation with (or acquire substantially all the assets of) another institution, a question arises for taxpayers using the "experience method". How should the revised experience of the surviving or new institution be computed?

CCR Section 24348(b)(3)(F) provides guidelines on this subject. It provides that a new loss ratio be computed based upon a combination of the ratios for the banks or savings & loans involved. The new ratio is computed by combining the ratios of each of the entities for the income year prior to the year of the merger, consolidation, or acquisition. This is done in the proportion of each entity's outstanding loans (eligible loan base) to the total outstanding loans of all the entities at the date of merger, consolidation, or acquisition. This method is applicable to all mergers, consolidations, or acquisitions occurring within the six-year (or three-year) period from which this loss ratio is derived.

EXAMPLE: On June 30, 1991 Bank B merges into Bank A creating AB. Various information, including their prior six year eligible loans and net charge offs were as follows:

<table>
<thead>
<tr>
<th>BANK A</th>
<th>BANK B</th>
<th>COMBINED</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eligible Loans at 6/30/91</td>
<td>12,000</td>
<td>3,000</td>
</tr>
<tr>
<td>Reserve Balance at 12/31/90</td>
<td>100</td>
<td>65</td>
</tr>
<tr>
<td>Eligible Loans at 12/31/91</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Net Combined Charge-Offs for 1991</td>
<td>N/A</td>
<td>N/A</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>YEAR</th>
<th>NET ELIGIBLE LOANS</th>
<th>CHARGE OFFS</th>
<th>RATIO</th>
</tr>
</thead>
<tbody>
<tr>
<td>1985</td>
<td>4,000</td>
<td>45</td>
<td>0.0113</td>
</tr>
<tr>
<td>1986</td>
<td>5,000</td>
<td>50</td>
<td>0.0100</td>
</tr>
<tr>
<td>1987</td>
<td>7,000</td>
<td>40</td>
<td>0.0057</td>
</tr>
<tr>
<td>1988</td>
<td>9,000</td>
<td>60</td>
<td>0.0067</td>
</tr>
</tbody>
</table>

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## Bank A

<table>
<thead>
<tr>
<th>Year</th>
<th>Net Eligible Loans</th>
<th>Charge Offs</th>
<th>Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>1989</td>
<td>11,000</td>
<td>30</td>
<td>0.0027</td>
</tr>
<tr>
<td>1990</td>
<td>10,000</td>
<td>20</td>
<td>0.0020</td>
</tr>
</tbody>
</table>

### Total and Averages

- **6-Year Total**: 46,000 loans with 245 charge-offs, **Ratio**: 0.0384
- **3-Year Total**: 30,000 loans with 110 charge-offs, **Ratio**: 0.0114
- **6-Year Weighted Average** (245/46,000): 0.0053
- **6-Year Simple Average**: 0.0064
- **3-Year Weighted Average** (110/30,000): 0.0037
- **3-Year Simple Average**: 0.0038

## Bank B

<table>
<thead>
<tr>
<th>Year</th>
<th>Net Eligible Loans</th>
<th>Charge Offs</th>
<th>Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>1985</td>
<td>1,000</td>
<td>10</td>
<td>0.0100</td>
</tr>
<tr>
<td>1986</td>
<td>1,000</td>
<td>20</td>
<td>0.0200</td>
</tr>
<tr>
<td>1987</td>
<td>1,500</td>
<td>30</td>
<td>0.0200</td>
</tr>
<tr>
<td>1988</td>
<td>2,000</td>
<td>40</td>
<td>0.0200</td>
</tr>
<tr>
<td>1989</td>
<td>2,000</td>
<td>60</td>
<td>0.0300</td>
</tr>
<tr>
<td>1990</td>
<td>2,500</td>
<td>70</td>
<td>0.0280</td>
</tr>
</tbody>
</table>

### Total and Averages

- **6-Year Total**: 10,000 loans with 230 charge-offs, **Ratio**: 0.1280
- **3-Year Total**: 6,500 loans with 170 charge-offs, **Ratio**: 0.0780
- **6-Year Weighted Average** (230/10,000): 0.0230
- **6-Year Simple Average**: 0.0213
- **3-Year Weighted Average** (170/6,500): 0.0262
- **3-Year Simple Average**: 0.0260

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Therefore, based upon their highest average percentages the new loss ratio for 1985 through 1990 is computed as:

**STEP 1** Computation of highest average, computed as:

Eligible loans outstanding at date of merger divided by total loans times highest average percentage or:

<table>
<thead>
<tr>
<th>BANK A</th>
<th>SIX YEAR</th>
<th>THREE YEAR</th>
</tr>
</thead>
<tbody>
<tr>
<td>(12,000/15,000) x .0064 =</td>
<td>.0051</td>
<td>(12,000/15,000) x .0038 =</td>
</tr>
<tr>
<td>BANK B</td>
<td>(3,000/15,000) x .0230 =</td>
<td>.0046</td>
</tr>
<tr>
<td>Total %</td>
<td>.0097</td>
<td></td>
</tr>
</tbody>
</table>

**STEP 2** Computation of the three and six-year bad debt average ratio:

<table>
<thead>
<tr>
<th>YEAR</th>
<th>NET ELIGIBLE LOANS</th>
<th>CHARGE OFFS</th>
<th>6-YEAR RATIO</th>
<th>3-YEAR RATIO</th>
</tr>
</thead>
<tbody>
<tr>
<td>1986</td>
<td></td>
<td>0.0097</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>1987</td>
<td></td>
<td>0.0097</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>1988</td>
<td></td>
<td>0.0097</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>1989</td>
<td></td>
<td>0.0097</td>
<td>1</td>
<td>0.0082</td>
</tr>
<tr>
<td>1990</td>
<td></td>
<td>0.0097</td>
<td>1</td>
<td>0.0082</td>
</tr>
<tr>
<td>1991</td>
<td>17,000</td>
<td>100</td>
<td>0.0059</td>
<td>0.0059</td>
</tr>
</tbody>
</table>

Total 0.0544 0.0223
Average 0.0091 0.0074

1Per six-year computation above, maximum
2Per three-year computation above, maximum
3The ratio for the year of the merger is computed as if the merger occurred on January 1, 1991.

**STEP 3** Computation of AB’s 1991 allowable deduction:

The maximum reserve balance as of 12/31/91 is computed as the eligible loans at 12/31/91 x highest % (which is the six year average) or

\[
17,000 \times 0.0091 = 155
\]

Combined beginning reserve as of 1/1/91 165
Less combined net charge offs for 100

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated
1991
Difference  65
Allowable deduction for 1991  90

NOTE: The revised percentages computed by step one for 1985 through 1990 are to be used by taxpayers for all bad debt computations for these years unless there is another merger. In that case taxpayer would have to re-compute their bad debt deduction per the above including the newly acquired bank.

See also Bank & Financial Handbook Section 0464, MERGER/LIQUIDATION TAX EFFECTS.
0541 MERGERS OF FINANCIALS—EFFECT ON THE BAD DEBT PROVISION / RESERVE COMPUTATION

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R&TC Section 24348(a)(1)(B) provides, in the discretion of the Franchise Tax Board, the use of the reserve method of accounting for bad debts for banks, savings & loan associations, and financial corporations. CCR Section 24348(b) does not apply to financial corporations other than savings & loan associations.

CCR Section 24348(b)(3)(F) provides for the computation of the reserve for bad debts for merged banks or savings & loan associations. CCR Section 24348(b)(3)(F) cannot be cited as authority for a financial corporation, other than a savings & loan association, to compute the merged bad debt reserve. Instead, the financial corporation must look to the Revenue and Taxation Code for authority. The method used to compute the bad debt reserve following the merger of two or more financial corporations must result in a reasonable provision. Using our discretion, we may audit the taxpayer's method. The taxpayer must show that we abused our discretion if the FTB proposes adjustments to the bad debt reserve.

Depending on the taxpayer's facts and circumstances, the method used in CCR Section 24348(b)(3)(F) may be a reasonable method. Likewise, the following example may be a reasonable method depending on the taxpayer's facts and circumstances:

Assume that the facts are the same as the example in Bank & Financial Handbook Section 0540, MERGERS—EFFECT ON THE BAD DEBT PROVISION/RESERVE COMPUTATION, except that A & B are financial corporations that are not banks or savings & loan associations.

<table>
<thead>
<tr>
<th>ELIGIBLE LOANS</th>
<th>NET CHARGE-OFFS</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>BANK A</td>
<td>BANK B</td>
</tr>
<tr>
<td>5,000</td>
<td>1,000</td>
</tr>
<tr>
<td>TOTAL</td>
<td>TOTAL</td>
</tr>
<tr>
<td>6,000</td>
<td>70</td>
</tr>
</tbody>
</table>

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.
AB’s 1991 bad debt deduction is computed as:
Reserve balance as of 12/31/91, computed as:
Six year net charge-offs/six year eligible loans x eligible loans at 12/31/91

\[
\frac{520}{68,000} \times 17,000 = 130
\]
Combined beginning reserve, as of 1/1/91
Less net 1991 charge-offs
Difference
Allowable deduction for 1991

Note: Generally, financial corporations are limited to the six-year average based upon the Black Motor formula. Facts and circumstances may provide for a different reserve, but the burden of proof is on the taxpayer.
0542  COMBINED REPORTING AND THE BAD DEBT RESERVE

The bad debt reserve computation must be done on a separate basis for each bank or financial corporation included in the combined report. Note that this requirement is not restricted to taxpayers but applies to all companies in the combined report. A single combined computation cannot be made. Offices or branches of a bank or financial corporation are not separate legal entities. Accordingly, their loss experience is to be reflected in the bank or financial corporation of which they are an office or a branch.

The reason separate entity bad debt reserve computation must be made is that the combined report of a bank or savings & loan association usually includes financial corporations and general corporations. The bank or savings & loan association would be subject to the CCR Section 24348(b) rules. Financial corporations come under the general provisions of CCR Section 24348. General corporations cannot use the reserve method.
0544 INTEREST EXPENSE ALLOCABLE TO TAX-EXEMPT OBLIGATIONS

California does not conform to the new federal rules for financial corporations regarding allocation of interest expense to tax-exempt obligations since all interest income is included in the measure of tax.
0548 ACCOUNTING METHODS

Bank & Financial Handbook Section 0548.1 – Loan Liquidation Method
Bank & Financial Handbook Section 0548.2 – Reserve Method
Bank & Financial Handbook Section 0548.3 – Cash Method of Accounting
Bank & Financial Handbook Section 0548.4 – Original Issue Discount
Bank & Financial Handbook Section 0548.5 – Change of Accounting Methods/Mergers
0548.1 Loan Liquidation Method

Rev. Proc. 94-29 obsoletes earlier revenue rulings that provided taxpayers with the loan liquidation method of accounting. Taxpayers may continue to use the loan liquidation method prior to adoption of the principle-reduction method as allowed under Rev. Proc. 94-29. See also Bank & Financial Handbook Section 0406.3, THE LOAN LIQUIDATION METHOD FOR CASH BASIS TAXPAYERS.
0548.2 Reserve Method

This section is provided for historical reference only. CCR Section 24348(b) is repealed and is not applicable for taxable years beginning on or after January 1, 2002. The use of the reserve method of accounting for bad debts by banks and savings & loans is severely limited by IRC Section 585 to "small banks" as defined in IRC Section 585(c). Financials are no longer allowed to use the reserve method of accounting for bad debts. For an explanation of the current rules regarding the deduction for bad debts for banks and savings & loans, see Bank & Financial Handbook Section 0504, PROVISION FOR BAD DEBTS—FEDERAL AND CALIFORNIA METHOD.

For tax years beginning after 1986, the Tax Reform Act repealed the bad debt reserve method for all but small banks and thrift institutions. California continues to allow the reserve method for all banks and financial corporations.
0548.3 Cash Basis Method Of Accounting

Effective for years beginning after 12/31/86, the Tax Reform Act of 1986 prohibited use of the cash method of accounting for C corporations (IRC Section 448). There is an exception for corporations with less than $5,000,000 in gross receipts (IRC Section 448(c)). Banks, savings & loan associations and financial corporations are C corporations.

California conformed to IRC Section 448 (R&TC Section 24654) effective for income years beginning on or after January 1, 1987.
0548.4 Original Issue Discount

Effective 1/1/87, California adopted federal provisions concerning original issue discount with a few exceptions; see R&TC Sections 24990 through 24994. The major exception is the definition of tax-exempt obligations. Most securities exempt for federal income tax purposes are still taxable under the franchise tax. See also Bank & Financial Handbook Section 0408, METHODS OF TREATMENT OF ORIGINAL ISSUE DISCOUNT.
0548.5 Change Of Accounting Method / Mergers

See Bank & Financial Handbook Section 0464, MERGER/LIQUIDATION TAX EFFECTS.
0562 STATE ADJUSTMENTS TO INCOME OBTAINED FROM ANNUAL REPORTS OF FOREIGN PARENTS

Bank & Financial Handbook Section 0562.1 – Revaluation of Securities Accounts
Bank & Financial Handbook Section 0562.2 - Director Payments
Bank & Financial Handbook Section 0562.3 - Reserves and Provisions To Reserves
0562.1  State Adjustments To Income Obtained From Annual Reports Of Foreign Parents—Revaluation Of Securities Accounts

Often the accounting standards of foreign countries allow for the write-down of securities to market value. This is a common practice in Japan and other Asian countries, as well as some European countries. Unlike U.S. banks, (which are forbidden from investing in publicly held companies) foreign banks are often major investors in stock of other companies. For financial statement purposes, the foreign banks may claim a loss for the devaluation of any securities held by them. Since in most cases, a combined report that includes a foreign parent will be based upon the financial statements of the foreign parent, the devaluation is included in financial statement income. The devaluation is not an allowable tax deduction. As a result of the devaluation, the foreign bank will reflect a lower cost basis upon the subsequent disposition of the securities. When the securities are disposed of, the bank is entitled to an adjustment to the basis of the securities, basically restoring the original cost amount.

If the bank is able to trace the securities sold, the appropriate tax basis will be allowed. Since the tracing process may be impractical or even impossible, the audit practice now shall be to allow an amortization of the disallowed devaluation, commencing with the year of disallowance. The amortization shall be over either the average holding period of the securities written down, based on actual experience, or a five-year period. The average holding period can be estimated as the ratio of the value of securities sold during the year to the total value of the portfolio.

Audit techniques:

- Determine the value of securities held at the beginning of the year.
- Determine the value of the securities held at the end of the year, adjusted for write-downs during the year and transfers of securities.
- Compute the average portfolio value \((1 + 2)/2\).
- Divide the result by the value of securities sold during the year, including securities held to maturity. The result will represent the average holding period.
0562.2  State Adjustments To Income Obtained From Annual Reports Of Foreign Parents—Directors Payments

Japanese Banks:

For financial reporting purposes payments to directors may be shown as an additional expense deducted from final net income. The amount is allowable as an additional tax deduction and also should be included in the payroll factor.
0562.3  State Adjustments To Income Obtained From Annual Reports Of Foreign Parents—Reserves And Provisions To Reserves

Bank & Financial Handbook Section 0562.31 - Bad Debts
Bank & Financial Handbook Section 0562.32 – Provisions and Reserves for Accounts other Bad Debts
0562.31 State Adjustments To Income Obtained From Annual Reports Of Foreign Parents—Reserves And Provisions To Reserves (Bad Debts)

This section is provided for historical reference only. CCR Section 24348(b) is repealed and is not applicable for taxable years beginning on or after January 1, 2002. The use of the reserve method of accounting for bad debts by banks and savings & loans is severely limited by IRC Section 585 to "small banks" as defined in IRC Section 585(c). Financials are no longer allowed to use the reserve method of accounting for bad debts. For an explanation of the current rules regarding the deduction for bad debts for banks and savings & loans, see Bank & Financial Handbook Section 0504, PROVISION FOR BAD DEBTS—FEDERAL AND CALIFORNIA METHOD.

Be aware that the bad debt reserve and bad debt reserve provisions may not be calculated in a manner consistent with California law or there may instances in which for foreign financial statement purposes, no bad debt provision is allowed. In such cases, an attempt should be made to develop the correct provision (and bad debt reserve balance) for state purposes.
0562.32 State Adjustments To Income Obtained From Annual Reports Of Foreign Parents—Reserves And Provisions To Reserves (Provisions And Reserves For Accounts Other Than Bad Debts)

It is very common for foreign financial statements to contain provisions and reserves, which are not allowable for state purposes. A careful review of the financial statements should disclose these items.
This section is provided for historical reference only. CCR Section 24348(b) is repealed and is not applicable for taxable years beginning on or after January 1, 2002. The use of the reserve method of accounting for bad debts by banks and savings & loans is severely limited by IRC Section 585 to "small banks" as defined in IRC Section 585(c). Financials are no longer allowed to use the reserve method of accounting for bad debts. R&TC Section 23457(b)(2) was amended in 2002, effective for taxable years beginning on or after January 1, 2002, and the reasonable addition to a reserve for bad debts was removed as an item of tax preference. For an explanation of the current rules regarding the deduction for bad debts for banks and savings & loans, see Bank & Financial Handbook Section 0504, PROVISION FOR BAD DEBTS—FEDERAL AND CALIFORNIA METHOD.

For years beginning after 1982, IRC Section 291 required that banks and savings & loan associations with excess bad debt deductions (a deduction greater than the amount of deduction the six-year moving average method would allow) or interest expense incurred to carry tax exempt obligations to reduce the deduction by 15%. The Tax Reform Act of 1984 increased the reduction to 20%.

The Tax Reform Act of 1986 deleted the cross-reference to IRC Section 593 (S&L bad debts). Therefore, IRC Section 291(e)(1)(A) only cross-references IRC Section 585 (bank bad debts). The Tax Reform Act of 1986 eliminated the use of the percent of asset method to compute the reserve. Savings & loan associations could continue to use the experience method (which will not produce excess bad debts) or the percentage of income method. The purpose of the percentage of income method is to lower the effective tax rate. It would not be consistent to use IRC Section 291(e)(1)(A) to increase the effective tax rate.

P.L. 101-508 repealed IRC Section 291(e)(1)(A) as deadwood language (a term used in the hearing reports to describe expired or obsolete provisions). The only cross-reference was to banks. Large banks cannot use the reserve method. Small banks are limited to the experience method. Thus, there are no potential excess bad debts in the federal scheme for banks.
0567.1 Alternative Minimum Tax—20% Disallowance Of Certain Deductions Generating Bank Tax Preferences

This section is provided for historical reference only. CCR Section 24348(b) is repealed and is not applicable for taxable years beginning on or after January 1, 2002. The use of the reserve method of accounting for bad debts by banks and savings & loans is severely limited by IRC Section 585 to "small banks" as defined in IRC Section 585(c). Financials are no longer allowed to use the reserve method of accounting for bad debts. R&TC Section 23457(b)(2) was amended in 2002, effective for taxable years beginning on or after January 1, 2002, and the reasonable addition to a reserve for bad debts was removed as an item of tax preference. For an explanation of the current rules regarding the deduction for bad debts for banks and savings & loans, see Bank & Financial Handbook Section 0504, PROVISION FOR BAD DEBTS—FEDERAL AND CALIFORNIA METHOD.

For income years beginning on or after January 1, 1987 California conformed to IRC Section 291(e)(1)(A) without exception (R&TC Section 24449). IRC Section 291(e)(1)(A) only cross references banks. Since R&TC Section 24449 was not modified to reference savings & loan associations or financial corporations, the 20% disallowance does not apply for these entities.

Since California uses a different method in computing the allowable bad debt provisions for banks from those methods specified in the IRC, it follows that any adjustment due to excess bad debt deductions will be different for California purposes. For the most part, this adjustment will not be shown separately from the federal bad debt provision. Since the federal provision is always added back in the computation of income for California purposes, the only concern should be if such adjustment to income is stated separately and not reflected in the adjustments for California purposes.

An adjustment reducing interest expense is, however, more likely to be reflected on the state return. Since the federal adjustment is for the purpose of reducing interest expense of banks and savings & loan associations that carry tax-exempt obligations, it should not be reflected for California purposes, since for franchise tax purposes there is no class of exempt income.
0567.11 Alternative Minimum Tax—Excess Bad Debt Reserves

This section is provided for historical reference only. CCR Section 24348(b) is repealed and is not applicable for taxable years beginning on or after January 1, 2002. The use of the reserve method of accounting for bad debts by banks and savings & loans is severely limited by IRC Section 585 to "small banks" as defined in IRC Section 585(c). Financials are no longer allowed to use the reserve method of accounting for bad debts. R&TC Section 23457(b)(2) was amended in 2002, effective for taxable years beginning on or after January 1, 2002, and the reasonable addition to a reserve for bad debts was removed as an item of tax preference. For an explanation of the current rules regarding the deduction for bad debts for banks and savings & loans, see Bank & Financial Handbook Section 0504, PROVISION FOR BAD DEBTS—FEDERAL AND CALIFORNIA METHOD.

Effective for years ending in 1988 for banks, the excess bad debt provisions are those resulting in a larger provision than would have been allowed under the experience method (the six-year moving average method). The difference between the provision allowable under the experience method and the method used by the taxpayer is to be reduced by 20%. This may end up being reflected on the tax return in two manners; either the provision is reduced by the 20% amount or an additional adjustment to income is made to account for the 20% reduction in the allowable provision.

P.L. 101-508 amended IRC Section 57(a)(4) and repealed IRC Section 291(e)(1)(A). The amendment and repeal was effective for federal purposes on the date of enactment, which was November 5, 1990.

The purpose of the amendment to IRC Section 57(a)(4) (AMT provision) and the repeal of IRC Section 291(e)(1)(A) was to eliminate deadwood.

SB 169 conformed R&TC Section 23457 (IRC Section 57) and RTC Section 24449 (IRC Section 291) to the changes made by P.L. 101-58. SB 169 became law on July 16, 1991.

R&TC Section 23051.5(a)(3) provides:

Subtitle G (Tax Technical Correction) and Part I of Subtitle H (Repeal of Expired or Obsolete Provisions) of the Internal Reconciliation Act of 1990 (Public Law 101-508) modified numerous provisions of the Internal Revenue Code and provisions of prior federal acts, some of which are incorporated by reference into this part. Unless otherwise provided, the provisions described in the preceding sentence, to the extent that they modify provisions that are incorporated into this part, are declaratory of existing law and shall be applied in the same manner and for the same periods as specified in the Revenue Reconciliation Act of 1990.
An argument has been made that the above language controls the effective date of the state conformity to the repeal of IRC Section 291(e)(1)(A).

The federal repeal of IRC Section 291(e)(1)(A) was a true elimination of deadwood or obsolete provisions. California never conformed to IRC Sections 585 and 593. Since California never conformed to those sections, the repeal of IRC Section 291(a)(1)(A) or for that matter IRC Section 57(a)(4) are not declaratory of existing state law. Thus R&TC Section 23051.5(a)(3) is not controlling in respect to the effective date.

R&TC Section 23051.5(a)(3) specifically states that the provisions incorporated by reference to P.L. 101-508 "shall be applied in the same manner and for the same period as specified in the Revenue Reconciliation Act of 1990." P.L. 101-508, Section 11821, addresses the effective date of the federal act. This section contains a "savings provision" which states that if any provision amended or repealed by the act applied to any item of income or deduction taken into account before the enactment date of the act, and the treatment of the item under the act would (without regard to the amendments made by the act) affect tax liability for the periods ending after the enactment date, then nothing in the act amendments shall be construed to affect the treatment of such income or deduction item for the purposes of determining tax liability for the periods ending after the enactment date.

For federal purposes, the amendment/repeal of IRC Section 57(a)(4) and IRC Section 291(e)(1)(A) were revenue neutral as the federal provisions were deadwood or obsolete. For SB 169 to "be applied in the same manner", which includes being consistent with the savings provision of P.L. 101-508, the amendments must be construed as not affecting the 1990 tax liability, e.g., the position that the state conformed effected some time prior to 11/5/90 is not revenue neutral.

The controlling language for determination of the effective date of the SB 169 provisions is found in R&TC Sections 23051(a) and 23058.

R&TC Section 23051.5(a) cross-references R&TC Section 17024.5(a) as it relates to the specified date. The specified date identifies which version of the Internal Revenue Code applies for state purposes.

The specified date for income years beginning on or after January 1, 1990, and on or before December 31, 1990 is the IRC section in effect as of January 1, 1990. The changes made by P.L. 101-508 to IRC Section 57(a)(4) and IRC Section 292(e)(1)(A) were effective for federal purposes on November 5, 1990. The changes could not have been in effect as of January 1, 1990.

The specified date for income years beginning on or after January 1, 1991, and on or before December 31, 1991 is the IRC section in effect as of January 1, 1991. The changes made by P.L. 101-508 to IRC Sections 57(a)(4) and 291(e)(1)(A) were included in the January 1, 1991 IRC.
SB 169 was a tax levy bill that became effective on July 16, 1991. R&TC Section 23058 provides in part:

Unless otherwise specifically provided herein, the provisions of any act:
(a) Which affect the imposition or computation of taxes...shall be applied to income years beginning on or after January 1 of the year in which the act takes effect.

Based on the above, the proper conclusion is that the effective date of the SB 169 amendments to R&TC Sections 23457 and 24449 is January 1, 1991. The 20% adjustment for excess bad debts was effective for income year 1988 - 1990.
0567.12 Alternative Minimum Tax—Interest Expense

Effective for years ending in 1988, interest expense incurred to carry tax-exempt obligations is subject to a 20% reduction. R&TC Section 24449 implemented the provisions of IRC Section 291, which in part, covers this item. Since for franchise tax purposes all obligations are subject to tax, this section has no effect on banks and savings & loan associations subject to the franchise tax.

If a bank or savings & loan association is subject to the income tax, then an adjustment should be made to reduce by 20% the deduction for interest expense incurred to carry tax exempt obligations. See also Bank & Financial Handbook Section 0600, PREFERENCE TAX.
0600 ALTERNATIVE MINIMUM TAX—INCOME YEARS ENDED DECEMBER 31, 1987 AND EARLIER

This section is provided for historical reference only. CCR Section 24348(b) is repealed and is not applicable for taxable years beginning on or after January 1, 2002. The use of the reserve method of accounting for bad debts by banks and savings & loans is severely limited by IRC Section 585 to "small banks" as defined in IRC Section 585(c). Financials are no longer allowed to use the reserve method of accounting for bad debts. R&TC Section 23457(b)(2) was amended in 2002, effective for taxable years beginning on or after January 1, 2002, and the reasonable addition to a reserve for bad debts was removed as an item of tax preference. For an explanation of the current rules regarding the deduction for bad debts for banks and savings & loans, see Bank & Financial Handbook Section 0504, PROVISION FOR BAD DEBTS—FEDERAL AND CALIFORNIA METHOD.

All banks and financial corporations are subject to the tax on preference income. In addition to the tax preferences applicable to all corporations (excess depreciation on real property and excess of percentage depletion over basis), banks and financial corporations are subject to a tax preference on the portion of the bad debt deduction that exceeds the deduction that would have been taken if the taxpayer had been using the actual loss experience based on a six-year moving average.

Since the Franchise Tax Board has not adopted regulations under R&TC Section 23401(b) pertaining to this tax preference item, Treas. Reg. Section 1.57-1(g)(4) is used for guidance.

Treas. Reg. Section 1.57-1(g)(4) provides that the beginning balance for the first year in which the tax is imposed (for California purposes 1971) is to be the hypothetical reserve calculated on the basis of the preceding five years’ experience, rather than the actual reserve balance at that time. The beginning balance for each subsequent year is the beginning balance of the preceding year. This is decreased by bad debt losses during such year and increased both by recoveries of debts within the year and the lower of the deduction allowable under the experience method or the amount of the deduction actually allowed for the year. Thus, the hypothetical reserve is carried with appropriate adjustments, through the years subsequent to the base year (1971).

Neither the regulation cited above, nor the example thereunder, addresses the situation when the beginning balance in years subsequent to the base year, calculated according to the method outlined above, is negative. If this should happen, it should be assumed that an amount sufficient to bring the hypothetical reserve to zero was allowed in the preceding year, since the concept of a negative reserve, hypothetical or actual, is antithetical to the theory of a reserve for bad debts. See Legal Memo 548.
Treas. Reg. Section §1.57-1(h)(1)(ii) provides for a zero beginning balance of the hypothetical reserve for the first year of existence for those banks and financial corporations formed after 1971.

An example of the computation of the excess bad debt deduction subject to preference tax follows on the next page:

<table>
<thead>
<tr>
<th>Year</th>
<th>Net Uninsured Loans</th>
<th>Losses (Net of Recoveries)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>$10,000,000</td>
<td>$30,000</td>
</tr>
<tr>
<td>1981</td>
<td>10,900</td>
<td>(1,500)</td>
</tr>
<tr>
<td>1982</td>
<td>11,650,000</td>
<td>116,000</td>
</tr>
<tr>
<td>1983</td>
<td>12,300,000</td>
<td>600</td>
</tr>
<tr>
<td>1984</td>
<td>13,120,000</td>
<td>20,500</td>
</tr>
<tr>
<td>1985</td>
<td>14,000,000</td>
<td>12,000</td>
</tr>
<tr>
<td>Total</td>
<td>$71,970,000</td>
<td>$177,600</td>
</tr>
</tbody>
</table>

Hypothetical Reserve at 12/31/85 \( \frac{\$177,600}{\$71,970,000} \times \$14,000,000 = \) \$34,548

Hypothetical Reserve at 1/1/85 (per prior years return and assumed to be correct for purposes of this example)

<table>
<thead>
<tr>
<th></th>
<th>Hypothetical Reserve at 1/1/85</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less: Net Losses</td>
<td>(12,000)</td>
</tr>
<tr>
<td>Balance before provision</td>
<td>15,479</td>
</tr>
<tr>
<td>Provision</td>
<td>50,000</td>
</tr>
<tr>
<td>Actual Bad Debt provision</td>
<td>19,069</td>
</tr>
<tr>
<td>Tax Preference Income</td>
<td>$30,931</td>
</tr>
</tbody>
</table>

The beginning balance in the hypothetical reserve can never be less than 0. If this should happen use the value of 0.

The hypothetical reserves, beginning and ending, are based on the financial entity's own experience. A substituted experience amount, such as a Federal Reserve District percentage is not to be used; if the taxpayer has been in existence less than six years, use the average ratio for the actual number of years in existence.

As with non-financial corporations, each California taxpayer is entitled to an exclusion of $30,000 against its tax preference income.
The tax preference for a bank will usually be generated when the bank or savings & loan association uses any method other than the experience method to determine its bad debt reserve provision. A financial corporation will usually be subject to tax preference when it takes a deduction more than the six-year moving average method, also known as the "Black Motor" formula. If a bank or financial corporation claims only actual losses, it is not likely to be subject to the preference tax.
0604 ALTERNATIVE MINIMUM TAX—INCOME YEARS BEGINNING ON OR AFTER JANUARY 1, 1988

This section is provided for historical reference only. CCR Section 24348(b) is repealed and is not applicable for taxable years beginning on or after January 1, 2002. The use of the reserve method of accounting for bad debts by banks and savings & loans is severely limited by IRC Section 585 to "small banks" as defined in IRC Section 585(c). Financials are no longer allowed to use the reserve method of accounting for bad debts. R&TC Section 23457(b)(2) was amended in 2002, effective for taxable years beginning on or after January 1, 2002, and the reasonable addition to a reserve for bad debts was removed as an item of tax preference. For an explanation of the current rules regarding the deduction for bad debts for banks and savings & loans, see Bank & Financial Handbook Section 0504, PROVISION FOR BAD DEBTS—FEDERAL AND CALIFORNIA METHOD.

R&TC Sections 23400 through 23405 providing for the imposition of a tax on preference income were repealed for income years beginning on or after January 1, 1988. R&TC Sections 23400 through 23459 were enacted into law, effective 1/1/88, providing for an alternative minimum tax (AMT) for income years beginning on or after January 1, 1988. These sections of California Revenue and Taxation Code incorporate, with modifications, IRC Sections 55 to 59, concerning the alternative minimum tax, and IRC Section 53, authorizing a minimum tax credit. See also Bank & Financial Handbook Section 0567, ADJUSTMENT TO DEDUCTIONS SUBJECT TO TAX PREFERENCE OR ALTERNATIVE MINIMUM TAX for a related discussion.

The modifications are in each of three areas where the federal government requires that alternative minimum taxable income (AMTI) is calculated differently from regular taxable income:

- Adjustments in calculating the alternative minimum taxable income (AMTI).
- Adjustments to book income.
- Adjustment to current earnings after 1989.
- Items of tax preference.
- Limitation on use of credits.
- Minimum tax credit.

For the specifics as to the differences between the state and federal calculations, see R&TC Sections 23456, 23457, 23459 or various California tax services.
0604.1 Alternative Minimum Tax—Preference Income Resulting From Bad Debt Provisions Of Banks And Savings & Loan Associations

This section is provided for historical reference only. CCR Section 24348(b) is repealed and is not applicable for taxable years beginning on or after January 1, 2002. The use of the reserve method of accounting for bad debts by banks and savings & loans is severely limited by IRC Section 585 to "small banks" as defined in IRC Section 585(c). Financials are no longer allowed to use the reserve method of accounting for bad debts. R&TC Section 23457(b)(2) was amended in 2002, effective for taxable years beginning on or after January 1, 2002, and the reasonable addition to a reserve for bad debts was removed as an item of tax preference. For an explanation of the current rules regarding the deduction for bad debts for banks and savings & loans, see Bank & Financial Handbook Section 0504, PROVISION FOR BAD DEBTS—FEDERAL AND CALIFORNIA METHOD.

The alternative minimum tax for banks and savings & loan associations is computed by adding to taxable income the tax preference equal to the amount by which the deduction allowable for a reasonable addition to a reserve for bad debts exceeds the amount which would have been allowed if the institution had maintained its bad debt reserve on the basis of its actual experience. Note that the calculation of preference income relating to the bad debt deduction is the same as for years before 1988. See Bank & Financial Handbook Section 0604, PREFERENCE TAX/AMT—INCOME YEARS BEGINNING ON OR AFTER JANUARY 1, 1988.

The resulting figure, reduced by an exemption amount, is the income subject to the minimum tax. The exemption amount is $40,000 reduced by an amount equal to 25% of the amount by which the alternative minimum taxable income exceeds $150,000. See R&TC Section 23456 for the method as to determining AMTI.

Prior to 1991, IRC Section 57(a)(4) provided that excess bad debts were an item of preference income for banks and savings & loan associations. The Omnibus Budget Reconciliation Act of 1990 (OBRA '90) eliminated the cross-reference to banks in IRC Section 57(a)(4). The cross reference was obsolete as large banks could no longer use the reserve method for bad debts and small banks are limited to the experience method to compute the ending reserve balance.

R&TC Section 23457 does not provide for modification of IRC Section 57 concerning excess bad debts. Accordingly, R&TC Section 23457 does not apply to financial corporations as such entities are not defined in the IRC for AMT purposes.

The state conformed to the OBRA '90 provisions in 1991, effective January 1, 1991. Therefore, starting in 1991, excess bad debts are no longer considered an AMT item for banks.
See Bank & Financial Handbook Section 0567.11, ADJUSTMENT TO DEDUCTIONS SUBJECT TO TAX PREFERENCE OR ALTERNATIVE MINIMUM TAX—Excess Bad Debt Reserves.
0604.2 Alternative Minimum Tax Rate For Banks, Savings & Loan Associations And Financial Corporations

The alternative minimum tax rate is 7%, plus the "in-lieu rate" (the difference between the financial tax rate and the general tax rate) for banks, savings & loan associations, and financial corporations.
0604.3  Alternative Minimum Tax—Examples Of Computations

The following are two examples of the alternative minimum tax computation. It is assumed that the example year is 12/31/90 and the tax rates in effect at that time are 9% for general corporations and 10.758% for banks and financial corporations.

### Example (1)
**Bank A**
- **Taxable Income**: $1,000,000
- **Tax Financial Rate (10.758%)**: $107,588
- **Add Tax Preference Item(s)**: 100,000
- **Alternative Minimum Taxable Income (AMTI)**: $1,100,000

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exemption Amount</td>
<td>$40,000</td>
</tr>
<tr>
<td>Less 25% of Excess of AMTI over $150,000</td>
<td>237,500</td>
</tr>
<tr>
<td>Allowable Exemption</td>
<td>0</td>
</tr>
<tr>
<td>Alternative Minimum Taxable Income (AMTI) after exclusion</td>
<td>1,100,000</td>
</tr>
<tr>
<td>Alternative Minimum Tax (7%)</td>
<td>77,000</td>
</tr>
<tr>
<td>Add: In Lieu Tax Rate (1.458%) times taxable income (1,000,000)</td>
<td>14,580</td>
</tr>
<tr>
<td>Total</td>
<td>91,580</td>
</tr>
<tr>
<td>Excess Over Regular Tax</td>
<td>0</td>
</tr>
</tbody>
</table>

### Example (2)
**Bank B**
- **Taxable Income**: $110,000
- **Tax Financial Rate (10.758%)**: $11,834
- **Add Tax Preference Item(s)**: 100,000
- **Alternative Minimum Taxable Income (AMTI)**: $210,000

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exemption Amount</td>
<td>$40,000</td>
</tr>
<tr>
<td>Less 25% of Excess of AMTI over $150,000</td>
<td>15,000</td>
</tr>
<tr>
<td>Allowable Exemption</td>
<td>25,000</td>
</tr>
<tr>
<td>Alternative Minimum Taxable Income (AMTI) after exclusion</td>
<td>185,000</td>
</tr>
<tr>
<td>Alternative Minimum Tax (7%)</td>
<td>12,950</td>
</tr>
<tr>
<td>Add: In Lieu Tax Rate (1.458%) times taxable income (1,000,000)</td>
<td>1,604</td>
</tr>
<tr>
<td>Description</td>
<td>Amount 1</td>
</tr>
<tr>
<td>-----------------------------------------</td>
<td>----------</td>
</tr>
<tr>
<td>Taxable Income (110,000)</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>14,554</td>
</tr>
<tr>
<td>Excess Over Regular Tax</td>
<td>2,720</td>
</tr>
</tbody>
</table>
0800 NON-BUSINESS INCOME

The audit practice of the Franchise Tax Board has been to treat all income of banks and financial corporation as business income. CCR Section 25137-4.1(b) provides:

All income of banks and financial corporations shall be "business income" unless the income arises from an investment or activity that is not a banking function.

CCR Section 25120(a) defines business income as income arising from transactions and activity in the regular course of the taxpayer's trade or business (transactional test) and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations (functional test).

Although the following two decisions did not involve banks or financial corporations, they are important in the discussion of business versus non-business income.

The Board of Equalization held that gain on sale of stock was non-business income as "mere potential is insufficient to support a finding that the gains on these sales were business income under the functional test, Appeal of Occidental Petroleum Corporation, Opinion on Petition for Rehearing, June 21, 1983.

In the Appeal of Mark Controls Corporation, December 3, 1986 the Board of Equalization held that gain on sale of stock was not business income as "neither the stockholdings nor the assets or activities of either corporation constituted integral parts of the appellant's unitary operations at the times appellant decided to sell the stock". The facts presented to the Board did not support a business income conclusion.

Although the regulation implies that a bank or financial corporation may have non-business income, it has been the department's position (based on federal law and regulations), that all income of a U.S. bank or financial corporation is business income. Federal provisions restrict banking investments to banking or banking related activities, thus all such investments serve the banking function.

Many bank holding companies have subsidiaries that engage in activities not considered allowable for a national bank to engage in. For example, national banks may have subsidiaries that offer discount brokerage services inside and outside of the bank's home state, see Clark v. Securities Industry Assn., 93 L Ed 2d 757. Therefore, both the holding company and the non-bank subsidiaries might have non-business income.

Based on the above Board of Equalization decisions, it will be necessary to develop facts that demonstrate that the investment satisfies either the transactional test or the functional test. Under the
functional test, the facts must be developed to demonstrate that the investments or the assets they represent, were integrally related to or had become an integral part of the bank’s business.

National banks and savings & loan associations are regulated as to the investments they can make. Other domestic financial corporations are not as regulated, thus it will be even more important for the auditor to document the facts on these entities.

Foreign jurisdictions also impose restrictions on foreign banks, although they are not as stringent as the federal government. For example, many large foreign banks own large amounts of stock of major foreign corporations. Accordingly, the foreign bank may make investments unrelated to their banking activities. These investments should be treated as non-business income, absent a showing that the investments had become an integral part of the bank’s business. See also Bank & Financial Handbook Section 1000, APPORTIONMENT FACTORS.

Please note that:

Although the bank has a minority interest in a major corporation, there may still be a business relationship that meets the functional test. For example, the corporation uses the bank for their banking and funding (bond and stock issuance) needs.
**0900 Unity**

Many practitioners assume financial institutions and their subsidiaries are unitary. The assumption is based on federal provisions that restrict the business operations of financial institutions to financial or financial related activities.

Due to deregulation of the banking industry as well as the acquisition of domestic banks and financial corporations by foreign parent corporations, increased documentation and analysis of unitary relationships is necessary.

The same relationships that result in a determination of unity of general corporations apply to financial institutions. The purpose of this section of the handbook is to address those unique characteristics of banks and financial corporations.
0904 UNIQUE UNITARY CHARACTERISTICS OF BANKS AND FINANCIAL CORPORATIONS

Unique unitary characteristics may include:

- Flow of cash, which is the equivalent to inter-company sales.

Inter-company financing (flow of cash) among general corporations is viewed as an investment activity or as a unitary connection depending on the use of the funds. For example, the parent corporations’ use of a lock box system, control of cash flow to the subsidiary and general budget approval is a business practice used by many large corporations. All large corporations would be unitary if this was enough to justify combination. On the other hand, greater weight is given in a unitary determination where the parent loans funds to the subsidiary in order for the subsidiary to build a plant to better service the parent.

Among banks and financial corporations, inter-company financing is considered as equivalent to inter-company sales due to the financial nature of their business.

"We see no substantial difference between the economies resulting from centralized purchasing of shoes considered in the Edison California Stores case, supra, and those flowing from centralized borrowing of money by these Appellants. There was as much relationship between the loans made in California and in Maine by members of this group as there was between sales of shoes in California and Georgia by the corporations there under scrutiny.", Appeal of Public Finance Company, Public Finance, et al., December 29, 1958.

Bank liquidity problems may be solved through inter-company flow of cash or cash equivalents.

- Participation loans entered jointly by the common group.
- Loan guarantees between the common group.
- Major common customers—Does the taxpayer(s) concentrate loans to firms of the parent's country?
- Acquisition requirements or restrictions by regulatory agencies.
- Inter-company personnel transfers—What is the importance of these transfers?
- Significant changes in business operations after an acquisition.
For example, did the taxpayer change its loan policy from individual accounts to commercial accounts?

Did the taxpayer expand its international activities?

- Referral of customers in need of foreign exchange to the local agency of the parent.
0908    COMBINATION OF GENERAL AND FINANCIAL CORPORATIONS

CCR Section 25137-4.1 (effective for income years beginning before 1/1/96) and CCR Section 25137-4.2 (effective for income years beginning on or after 1/1/96) will apply where the combined report includes general corporations and bank or financial corporations and the bank or financial corporation is predominant. The general corporation's factors are determined in accordance with CCR Sections 25129 through 25136. Thus, the general corporation's intangibles are not included in the property factor. As a rule, the intangible assets of bank or financial corporations far exceed those of the general corporation. This would make inclusion of the general corporation's intangible assets in the property factor immaterial.

CCR Section 25137-10, effective 1/1/89, applies where the combined report includes general corporations and bank or financial corporations, and the general corporation's operations are dominant. The combination of a department store and its credit card subsidiary or an automobile manufacturer and its customer credit subsidiary are examples of a dominant general corporation with a unitary financial subsidiary.

For years prior to enactment of CCR Section 25137-10:

Legal Ruling 119, issued in 1954, first addressed the combination of general and financial corporations. Legal Ruling 119 concluded: "...because of the formula differences between general and financial corporations, it does not appear feasible to combine the companies..."

The proposition that the ability to file a combined report was dependent upon a showing that the separate accounting results are inappropriate was successfully attacked in Superior Oil Co. v. FTB, (1963) 60 CA and Honolulu Oil Corp. v. FTB, (1963) 60 CA 2nd. 417. These cases held that if the corporations are unitary, they must file a combined report.

The position set forth in Legal Ruling 119 was untenable in light of Superior and Honolulu. The FTB officially recognized this in 1974. We withdrew Legal Ruling 119 and issued Legal Ruling 370. Relying on these cases, Legal Ruling 370 concluded that a combined report was required when a general parent and financial subsidiary were unitary. Legal Ruling 370 also held that the standard UDITPA provisions should be used in the apportionment of income. Thus, intangibles were not reflected in the property factor. However, the Department indicated that different treatment under CCR Section 25137 might be appropriate in cases where the financial corporation is dominant.

The FTB defended Legal Ruling 370 in a suit for refund by Sears, Roebuck & Co. (L.A. Sup. Ct. #C248013). The court rejected the apportionment method set forth in Legal Ruling 370. The
assignment of income without consideration of a unitary subsidiary's note (intangible asset) did not give rise to a fair apportionment of income.

The staff of the FTB, based on its experience in the Sears case, concluded that the standard apportionment formula provided for in UDITPA would normally not fairly reflect the activities of a unitary business consisting of both general and financial corporations. This conclusion was based on the fact that the standard apportionment factor does not include intangibles. Thus, the principal income-producing asset of the financial is not included in the property factor.

In 1986, after much study of the issue, the department adopted an administrative policy of using a two-step apportionment process called pre-apportionment. Pre-apportionment will be discussed later in detail.

Audits were conducted pursuant to the use of pre-apportionment, which resulted in assessments and protests in some instances. In reviewing our chances of sustaining our assessment based on pre-apportionment, the FTB staff concluded that it would be very difficult as:

- At this point, Legal Ruling 370 was never revoked.
- Pre-apportionment was not adopted as a regulation.

To overcome these problems, the FTB staff set out to issue a regulation and establish a defensible policy for the period before the regulation would go final. As part of the process in establishing the regulation we asked for criticism of the pre-apportionment method. The criticism of pre-apportionment led to a reevaluation of the method and a decision to adopt another method. That method led to CCR Section 25137-10.

CCR Section 25137-10:

- Applies only when the combination includes general and financial corporations and the general corporation's business activity is predominant. An example would be the combination of a department store and their credit card subsidiary.

- The bank and financial corporations included in the combined report in accordance with CCR Section 25137-10 would look to CCR Section 25137-4.1 or CCR Section 25137-4.2 for numerator assignment of the apportionment factors.

- The regulation applies for income years beginning on or after January 1, 1989.

- CCR Section 25137-10 was amended in 1992 and states that the general corporation's receivables that arise from financing sales AND the financial corporation's intangibles are
included in the property factor, although they are weighted at 20%. However, please note that a Board Resolution, dated 12/2/91, states that the amendment of CCR Section 25137-10 is adopted for all years after 1/1/89 (California Administrative Code, Register 92, Number 12).

The policy of the FTB regarding combination of general and financial corporations for years up to the effective date of CCR Section 25137-10 follows:

- The Department would follow Legal Ruling 370.

- Unitary groups that include financial and general corporations that seek the inclusion of financial property would be allowed to do so in accordance with CCR Section 25137-10.

Unitary groups that were audited and adjusted by the Department under the pre-apportionment method, or filed returns using the pre-apportionment method, for income years beginning prior to the adoption of CCR Section 25137-10 were allowed to use pre-apportionment for all open years.

- If a unitary group chose to use a method other than that provided in Legal Ruling 370, it had to use that method for all open years.

Legal Ruling 370 was withdrawn by Legal Ruling 98-2 dated May 12, 1998. CCR Section 25137-10 is applicable for years beginning 1/1/89.
0912 ELEMENTS OF THE PRE-APPORTIONMENT FORMULA

Elements of the pre-apportionment formula are a resource factor, a payroll factor, and a sales factor.

For pre-apportionment formula purposes, the payroll and sales factors are computed under the normal rules used with respect to the payroll and sales factors. However, the resource factor is computed in a different manner.

The resource factor consists of the average total resources (including intangibles) at original cost plus capitalized rents, less any inter-company rentals. The total resources must be adjusted to:

- Exclude investment in combinable affiliates.
- Exclude inter-company receivables between the general and financial combined affiliates.
- Eliminate goodwill and to restore allowances for doubtful accounts and allowances for depreciation.
0916 NUMERATOR AND DENOMINATOR OF THE FACTORS

The denominator of each of the factors is the total factor of the general and financial corporation's property combined; the numerator of the factors is the total factor for each of the general and financial corporations. This, then, produces two ratios, one attributable to the general corporations and one to the financial corporations. Each ratio is applied to the total unitary business income to assign business income to the general corporations and to the financial corporations for apportionment within and without the state. An illustration of the pre-apportionment concept follows.

### General Corp. Financial Corp. Total

<table>
<thead>
<tr>
<th></th>
<th>General Corp.</th>
<th>Financial Corp.</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unitary Business Income</td>
<td>65,000</td>
<td>200,000</td>
<td></td>
</tr>
<tr>
<td>Sales</td>
<td>3,500,000</td>
<td>0</td>
<td>3,500,000</td>
</tr>
<tr>
<td>Interest Income</td>
<td>25,000</td>
<td>305,000</td>
<td>330,000</td>
</tr>
<tr>
<td>Total Revenue</td>
<td>3,525,000</td>
<td>305,000</td>
<td>3,830,000</td>
</tr>
<tr>
<td>Rent Expense</td>
<td>30,000</td>
<td>15,000</td>
<td>45,000</td>
</tr>
<tr>
<td>Payroll</td>
<td>250,000</td>
<td>95,000</td>
<td>345,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Assets</td>
<td>$2,781</td>
<td>$3,037</td>
<td>$1,185</td>
<td>$1,263</td>
</tr>
<tr>
<td>Add Reserve for Bad Debts</td>
<td>15</td>
<td>16</td>
<td>20</td>
<td>25</td>
</tr>
<tr>
<td>Allow. for Depreciation</td>
<td>110</td>
<td>200</td>
<td>6</td>
<td>7</td>
</tr>
<tr>
<td>Deduct:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Nonbusiness</td>
<td>(60)</td>
<td>(75)</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Investment in Subs.</td>
<td>(360)</td>
<td>(430)</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>I/C Receivables</td>
<td>0</td>
<td>0</td>
<td>(100)</td>
<td>(150)</td>
</tr>
<tr>
<td>Goodwill</td>
<td>(100)</td>
<td>(90)</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Totals</td>
<td>2,386</td>
<td>2,658</td>
<td>1,111</td>
<td>1,145</td>
</tr>
<tr>
<td>Beg. Balance</td>
<td>2,386</td>
<td></td>
<td>1,111</td>
<td></td>
</tr>
<tr>
<td>Totals</td>
<td>5,044</td>
<td></td>
<td>2,256</td>
<td></td>
</tr>
<tr>
<td>Average</td>
<td>2,522</td>
<td></td>
<td>1,128</td>
<td></td>
</tr>
<tr>
<td>Capitalized Rent</td>
<td>240</td>
<td></td>
<td>120</td>
<td></td>
</tr>
<tr>
<td>Totals</td>
<td>(a)$2,762</td>
<td>(b)$2,248</td>
<td>(c)$4,010</td>
<td></td>
</tr>
<tr>
<td>Ratio</td>
<td>68.8778%</td>
<td></td>
<td>31.1222%</td>
<td>100%</td>
</tr>
<tr>
<td>(a/c)</td>
<td></td>
<td></td>
<td>(b/c)</td>
<td></td>
</tr>
<tr>
<td>Total Payroll (000's)</td>
<td>(a) $250</td>
<td>(b) $95</td>
<td>(c) $345</td>
<td></td>
</tr>
</tbody>
</table>

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.
Payroll Factor Ratio  72.4638%  27.5362%  100%
    (a/c)  (b/c)
Total Sales  (a) $3,525  (b) $305  (c) $3,830
Sales Factor Ratio  92.0366%  7.9634%  100%
    (a/c)  (b/c)
Total Ratios  233.3782%  66.6218%  300%
Average Ratios  77.7927%  22.2073%  100%
Combined Business Income  $200,000
Pre-Apportioned Business Income  $155,585  $44,415

The above business income assigned to the general corporations and the financial corporations by the pre-apportionment formula is then apportioned within and without the state by use of the applicable industry formula.

The general corporations will use the standard three-factor formula. The financial corporations will use the apportionment formula required by CCR Section 25137-4.1 and CCR Section 25137-4.2.
BAD DEBT COMPUTATION WHEN TAXPAYERS ARE FILING A COMBINED REPORT

The bad debt computation must be done separately for each corporation in the combined report. See also Bank & Financial Handbook Section 0542, COMBINED REPORTING AND THE BAD DEBT RESERVE.
1000 APPORTIONMENT FORMULA (R&TC SECTION 25128 THROUGH R&TC SECTION 25137 AND CCR SECTION 25137-4.1 AND CCR SECTION 25137-4.2)

Unitary groups use CCR Section 25137-10 where the general business activity is predominant in the combined report. See also Bank & Financial Handbook Section 0908, COMBINATION OF GENERAL AND FINANCIAL CORPORATIONS.

Unitary groups use the special formula as set forth in CCR Section 25137-4.1 and CCR Section 25137-4.2 where the bank or financial corporations are the predominant business activity in the combined report. This special formula is commonly referred to as "The Total Resources Formula". The apportionment formula used for banks and financial corporations differs from that used by general corporations. A special formula is used in recognition of the fact that intangibles are the primary income producing assets utilized by banks and financials.

During 1990, the Multistate Tax Commission (MTC) attempted to draft a uniform apportionment scheme for bank and financial corporations and build consensus to support the new regulation. The effort was not successful until a large group of interested parties were brought into the regulation process. The MTC and the Federation of Tax Administrators (FTA) joined forces to sponsor the regulation. Industry was active through representation by the Financial Institutions State Tax Coalition (FIST), a coalition of several banks from throughout the country, the American Bankers Association and others. New York State, New York City and South Dakota represented states with more of a money-center point of view. States such as Minnesota, Tennessee, New Hampshire, North Dakota and others represented a market state point of view. California can be viewed as both a money center and market state.

CCR Section 25137-4.2 was promulgated effective for income years beginning on or after 1/1/96. The regulation is a compromise of the various money center and market state points of view, in conjunction with industry's and the state's desire of fair apportionment and ease of administration. Accordingly, compromise between the drafters may result in an item being reflected in the property factor but not the receipts factor, or that not all unitary property or receipts are included in the apportionment scheme.
1002 PROPERTY FACTOR

The property factor includes real and personal property owned (both tangible and intangible) and rented real and tangible personal property used in the business. Real property and tangible personal property is to be reflected at its original cost which is deemed to be federal tax cost basis. Owned intangible personal property is to be reflected at its cost basis for federal tax purposes. Loans are valued at their outstanding principal balance without regard to any reserve for bad debts. Credit card receivables are valued at their outstanding principal balance without regard to any reserve for bad debt. Effective 1/1/96, assets acquired at foreclosure are not included in the factor. Rental property is to be valued at eight times the net annual rental rate.

In addition to the property factor rules in CCR Section 25129 and CCR Section 25137, the following rules apply to the property factor denominator:

<table>
<thead>
<tr>
<th>CCR Section 25137-4.1 (Inc. Years Beg. Before 1/1/96)</th>
<th>CCR Section 25137-4.2 (Inc. Years Beg. On/After 1/1/96)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Goodwill is not included.</td>
<td>1. Goodwill is not included.</td>
</tr>
<tr>
<td>2. Coin and currency is included.</td>
<td>2. Coin and currency is not included.</td>
</tr>
<tr>
<td>3. Loans are included.</td>
<td>3. Loans are included.</td>
</tr>
<tr>
<td>4. Business income investments (other than loans) are included.</td>
<td>4. Business income investments (other than loans) are not included.</td>
</tr>
<tr>
<td>5. Purchased intangibles (other than loans) are not included.</td>
<td>5. Purchased intangibles (other than loans) are included.</td>
</tr>
<tr>
<td>6. Leased property is included.</td>
<td>6. Leased property is included.</td>
</tr>
</tbody>
</table>

The information provided in the Franchise Tax Board’s internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.
1004  EXCLUSIONS FROM THE PROPERTY FACTOR

- Allowance for Bad Debts: Receivables are reflected at their gross value.
- Allowance for Depreciation: Depreciable assets are reflected at their original cost.
- Goodwill.
- Inter-company receivables or loans from unitary affiliates.
- Investments in unitary affiliates.
- Assets that are custodial in nature and have a contra account in the liability section, i.e., assets held in trust.
- Contra Assets. An example of a contra asset would be customer liabilities under letters of credit issued under guarantee.
- Revaluation Adjustments to Assets. Often in the case of foreign parents, assets are re-valued in accordance with accounting standards in effect in the particular foreign country. The asset value used should approximate as closely as possible, the original cost of the asset. Such value would exclude the current revaluation adjustment and all previous revaluation adjustments.
- Other Reserves. These are often found in foreign financial statements.
- Financial Lease Property. Property that is subject to a financial lease and is deemed to have been sold subject to a financing arrangement. Hence, in essence the leased property is considered owned by the lessee and should not be reflected in the property factor of the bank or financial. However, because the financial lease is treated as a loan, the loan value is included in the factor.

Non-business Assets. It is unlikely that a domestic bank or financial corporation will have assets that are considered to be of a non-business nature, given the definition in CCR Section 25137-4.1(b), which states “All income of banks and financial corporations shall be “business income” unless the income arises from an investment or activity which is not a banking function.”
1006 NUMERATOR OF THE PROPERTY FACTOR

The property factor of the apportionment formula for banks and financial corporations is computed in accordance with CCR Section 25128 through CCR Section 25137 except as provided by CCR Section 25137-4.1 (effective for income years beginning before 1/1/96) and CCR Section 25137-4.2 (effective for income years beginning on or after 1/1/96).

As a general rule, under CCR Section 25137-4.1, intangible property and receipts are assigned based on employee activity or to the market state, if the bank or financial corporation is taxable in that state. Assignment of a loan based on office of origination is an example of looking to employee activity. The market state is the location of the bank's customer. For example, credit card receivables and receipts would be assigned to the customer's state if the bank or financial corporation is taxable in that state.

Effective 1/1/96, assets acquired through foreclosure are not included in the property factor.

The following rules apply to the property factor numerator:

<table>
<thead>
<tr>
<th>CCR Section 25137-4.1</th>
<th>CCR Section 25137-4.2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans are assigned to the office that originated the loan except for instances where a bank regulatory authority recognizes the loan as an asset of another location. Loans may be assigned to an offshore shell branch.</td>
<td>Loans are assigned to a regular place of business based on preponderance of substantive contacts. The taxpayer's books are presumed to be correct if the booking is consistent with regulatory requirements, the taxpayer's booking procedures are consistent with the preponderance of substantive contacts, and the taxpayer is consistent for other tax purposes. Loans cannot be assigned to a shell branch as it is not a regular place of business as defined by the regulation.</td>
</tr>
</tbody>
</table>

Participation loans are assigned to the office participating in the loan. Same as above.

Loans solicited by traveling loan officers are assigned to the office they work out of unless the loan is recognized by the regulatory agency as

Same as above.
<table>
<thead>
<tr>
<th>Asset Type</th>
<th>Assignment Rule</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit card receivables</td>
<td>Same as above.</td>
</tr>
<tr>
<td>Investments in securities</td>
<td>Not included.</td>
</tr>
<tr>
<td>Leased tangible personal property</td>
<td>Real personal property and tangible personal property, except for transportation property, is assigned to the state where the property is located. Transportation property is assigned to a state to the extent it was used in that state, i.e., based on the ratio of landings for aircraft. A motor vehicle is deemed to be used wholly in the state in which it is registered.</td>
</tr>
<tr>
<td>Real and tangible personal property</td>
<td>Same as Section 25137-4.1</td>
</tr>
<tr>
<td>Purchased loans</td>
<td>Purchased loans are included unless they are considered to be investment assets. A loan is any extension of credit resulting from direct negotiation between a lender and a customer. Loans do NOT include mortgage-backed securities. Purchased loans are assigned to the regular place of business with which it has a preponderance of substantive contacts.</td>
</tr>
<tr>
<td>Due from accounts</td>
<td>Not included.</td>
</tr>
</tbody>
</table>
out-of-state bank should be assigned to the state of commercial domicile. Banks maintain due from accounts from other banks for check clearing, customer services, CD's, etc.
1008  EXCLUSIONS FROM THE NUMERATOR OF THE PROPERTY FACTOR

All international banking facility (IBF) intangible assets (i.e. loans, etc.) are to be excluded from the numerator, provided that the taxpayer has complied with the regulations pertaining to IBFs. RTC Section 23044 requires the segregation of the assets and liabilities of the IBF on the books of the taxpayer.

See Bank & Financial Handbook Section 1004, EXCLUSIONS FROM THE PROPERTY FACTOR, for other exclusions that are applicable to both the numerator and denominator.
1020       AUDIT TECHNIQUES—REVIEW OF THE PROPERTY FACTOR

In General:

Obtain the tax audit work-papers used to develop the formula. The amounts shown in these work-papers should be reconciled with the taxpayer's annual reports, financial statements, branch statements, etc., as applicable. It is important to determine the taxpayer's methodology in accumulating the amounts reflected in the factors. Understanding the taxpayer's methodology will enable you to determine the correctness of the computations through a limited review of the taxpayer's records as opposed to a complete item-by-item analysis.
1022 AUDIT TECHNIQUES—DENOMINATOR OF THE PROPERTY FACTOR

To confirm that the denominator has been properly computed two steps are necessary:

Verify that total intangible assets have been included, excluding such items as investments in unitary subsidiaries and other inter-company assets, reserves against assets, contra assets, and goodwill. Often when reviewing the assets you will see account classifications used which are exclusive to banks and financials such as federal funds sold, customer's liabilities under acceptances and customers liabilities issued under letters of credit guarantee. It is important to determine the nature of these accounts to determine if they should be reflected in total property. Federal funds sold are receivables from the Federal Reserve. Customer's liabilities under acceptances may be represented as outstanding or purchased. Customer's liabilities under acceptances outstanding are the contingent liabilities of the bank to third parties for the acceptances of the bank's customers. A contra account is established on the asset side of the balance sheet for the purpose of offsetting the contingent liability account (an accounting treatment required by the Federal Reserve). Customer's liabilities under acceptances purchased are the customer's acceptances purchased by the bank. Liabilities issued under letters of credit guarantee are guarantees of payment, which are fully secured by a deposit.

Only federal funds sold and customer's liabilities under acceptances purchased represent assets included in the factor. Customer's liabilities under acceptances outstanding are contra liabilities. Liabilities issued under letters of credit guarantees represent only a certification that the bank has on deposit secured funds for payment to its depositor's customer. The best approach when faced with an unfamiliar account is to ask for a complete explanation as to its nature. Essentially, the objective is to reflect in the factor those assets that are the revenue producing assets of the business and to exclude those accounts that represent only additional disclosures of financial information. The balance sheet and supporting statements are a good source of information in this regard, since they reflect the book basis of the taxpayer and often have a breakdown of the various accounts. Goodwill will often be found under the "Other Assets" classification or the "Other Investments" category. The existence of contra assets may be disclosed in the annual reports in the description of the taxpayer's business activities. A review of the liabilities section of the balance sheet will often disclose accounts whose values closely reflect values of accounts located in the asset section of the balance sheet. Such liability accounts should be reviewed closely to determine if they are in fact contra asset accounts.

The accounts discussed above are only a few examples of the types of accounts you will encounter in your audits. The definitions of banking terminology at the beginning of this handbook may aid you in determining the nature of the accounts.

- Verify that the assets are reflected at their federal tax cost basis. In the audits of banks and financial corporations, the differences between federal tax cost basis and book basis is ordinarily not material as far as the property factor is concerned. This is because the vast
majority of assets of these institutions are of an intangible nature and not subject to large book/tax differences. The exception to the rule is the treatment of leased property (that is property in which the bank or financial is lessor). As increasing deregulation has occurred, banks and financials have moved extensively into the leasing of property. To be included in the property factor, such property must be considered property owned by the bank for federal tax purposes, i.e., an operating lease. If a financial lease is involved, the property should not be included in total property, since the transaction is merely a financing arrangement (i.e. a sale has occurred). However, any receivable created by the sale would be reflected in the factor.

Of primary concern is that the assets be reflected at cost, not after allowances for bad debts, amortization, etc. The balance sheet and supporting statements should provide sufficient detail to allow you to determine if the assets are in fact reflected at cost.

Because of the enactment of CCR Section 25137-4.2, effective for income years beginning 1/1/96, there will be different property amounts for the 12/95 ending property (used in the averaging of the 12/95 property), and the beginning property for 12/96 (used in the averaging of the 12/96 property). This is because the rules for what is to be included in the property factor under CCR Sections 25137-4.1 and 25137-4.2 are quite different. So for consistency purposes, when computing the income year ending 12/96 property factor, you must make appropriate adjustments to the 12/96 beginning property amounts before averaging so that the beginning property is computed under the CCR Section 25137-4.2 rules. This applies to the numerator as well.

**Foreign Parents**

The primary difficulty in developing the denominator of the property factor arises in the audits of foreign parent banks. Typically the source for review of the factor will consist solely of the annual report of the foreign parent. Often such reports are very brief and only of a summary nature. For this reason it is important that the auditor be aware of the accounting standards in the parent's country. A good source for such information is the brochures, tax and trade guides published by some of the larger CPA firms.

Useful information can also be obtained from the State Library and Moody's directory of financials. The most effective technique is through a detailed review of the annual reports coupled with an IDR (Information Document Request). Another common problem is the submission by the taxpayer of foreign financial statements that have not been translated into English. The auditor should make every attempt to have the statements provided in a translated fashion. In lieu of that, the auditor should insure that all key accounts are satisfactorily identified.

Determining the methodology used by the taxpayer in accumulating the factor information is especially important when conducting audits of foreign parents, since the accounting standards vary significantly from U.S. GAAP. It is common for foreign financial statements to reflect adjustments
such as revaluation of assets, write-downs of securities and numerous reserves that may be offset against the value of the assets included in the factor, all of which must be adjusted for in arriving at the correct value for factor purposes as well as income purposes. Another important consideration when dealing with foreign parents is the business activities in which they are engaging. Foreign nations often have far less restrictive rules for the activities banks may engage in. It is entirely possible that activities completely unrelated to banking activities may be reflected in their financial statements. A thorough review of the financial statements coupled with an interview of the taxpayer may disclose such activities. Other information sources are Moody's and filings with the Securities and Exchange Commission. The extent of your review into these areas should be tempered by the materiality of the issue.
1024 AUDIT TECHNIQUES—NUMERATOR OF THE PROPERTY FACTOR

The taxpayer's apportionment factor work-papers showing the factor distribution by the taxpayer are essential for an examination of the numerator. A review of these work-papers will provide insight into the taxpayer's methods for factor assignment and allow for the verification that all assets (excepting IBF assets) have been attributed to some location. The taxpayer's chart of accounts will provide valuable information since the account codes typically identify the office, branch locations, etc. Knowledge of these codes can be important in disclosing anomalies such as loans being assigned to a location for factor purposes different from the location where they are being booked. The chart of accounts can also provide valuable information such as the presence of contra accounts and inter-company transactions. Another valuable source of information is branch statements. A review of the branch statements will also provide information as to activities within California and activities with other branches that may have an impact on the factor (inter-company eliminations, assignment of intangibles, etc.).

There are several types of assets that may be difficult to assign to a specific location: loans, electronic funds transfers and leased property. Often taxpayers "park" these assets at locations (tax haven countries) at which they are not taxable. In the absence of a determination by a regulatory authority these assets should be assigned to their originating office or the taxpayer's commercial domicile. A determination by a regulatory authority as to the location of an asset is considered determinative (for intangible assets) for our purposes. If the taxpayer is claiming the assignment based upon determination by regulatory authority, it is important that the taxpayer be required to provide evidence to support that claim.

If there has been no determination by regulatory authority the following should be considered determinative as to the assignment location:

- Loans—Under CCR Section 25137-4.1, the office from which customers applied for the loan or in the case of a purchased loan, the office that purchased the loan. Under CCR Section 25137-4.2, loans are assigned to the regular place of business based on preponderance of substantive contacts. This information can be obtained from the taxpayer's loan portfolios or from a review of the taxpayer's methodology in assigning loans to specific locations.

- Electronic Funds—The originating office or in absence of other information the commercial domicile. A review of the annual report and the chart of accounts may be of assistance.

- Leased Property—The first issue to be addressed regarding leased property is the nature of the lease, i.e., is the lease transaction a financing arrangement involving the sale of property (a financial lease) or is it in fact a lease whereby the objective is to make a profit from the leasing of property (an operating lease). A review of the lease agreements is the only way to
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1026   HISTORICAL COSTING

See MATM 7120 for a detailed description. This typically is not a material issue in the audits of foreign parent banks, since their fixed assets are typically nominal in size when compared to their intangible assets, which by and large are relatively short-term in nature. If the fixed assets are material in nature, historical costing should be used.
1050 PAYROLL FACTOR

The payroll factor is computed in exactly the same manner as for all other types of taxpayers that apportion income. The denominator is based on total compensation everywhere and the numerator is based on total compensation in California. Compensation is defined as salaries, wages, commissions, the value of property and services provided by the taxpayer to the employees (such as room and board, housing, rent) and similar benefits whenever these payments would be considered to be taxable income to the employee under the provisions of the Internal Revenue Code, and the California Revenue and Taxation Code.

Forms DE-3 and 940 or 941 will provide sufficient information to compute or verify the payroll factor for banks or financials doing business in the United States. To be as accurate as possible, the amounts derived from such forms should be adjusted for accruals if the taxpayer is on the accrual basis. In most instances payroll of foreign operations will have to be supplied by the taxpayer. Such information can also often be obtained from annual reports.
1060  SALES FACTOR

For income years beginning on or after 1/1/93, the apportionment formula for most taxpayers has been modified to double-weight the sales factor. However, certain taxpayers engaged in a "qualified business activity" (agricultural extractive business activities) are required to apportion their business income using the standard three-factor formula, as of adoption of this section (RTC Section 25128(b)). This section was amended to include savings & loans under the single-weighted exception, effective 1/1/94. This section was again amended to include banking and financial business activities under the single-weighted exception, effective 1/1/96.

Recap of the weighting of the sales factor:

<table>
<thead>
<tr>
<th>YEAR</th>
<th>GENERAL CORPORATIONS</th>
<th>BANKS &amp; FINANCIALS</th>
<th>SAVINGS &amp; LOANS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Through 12/31/92</td>
<td>Single</td>
<td>Single</td>
<td>Single</td>
</tr>
<tr>
<td>1993</td>
<td>Double</td>
<td>Double</td>
<td>Double</td>
</tr>
<tr>
<td>1994 &amp; 95</td>
<td>Double</td>
<td>Double</td>
<td>Single</td>
</tr>
<tr>
<td>1996 on</td>
<td>Double</td>
<td>Single</td>
<td>Single</td>
</tr>
</tbody>
</table>

The "more than 50%" test for determining whether a taxpayer is in a qualified business activity applies to the combined gross business receipts of the unitary group. Once it is determined that a combined unitary group meets this test, the entire business income of the group will be apportioned using a single-weighted sales factor formula.

Prior to 1988, we would determine if an entity that owns credit card receipts was taxable in the customer's state to assign the factors. If the entity was not taxable in the customer's state, we would throw the property and receipts back to the state of commercial domicile. The Board of Equalization held in the Appeal of Finnegan Corporation, decided August 15, 1988 that "taxpayer" for the purposes of formula apportionment "means all corporations within the combined unitary group." The SBE held in Appeal of Huffy Corporation, decided April 22, 1999, that California will return to the Joyce rule for income years beginning on or after April 22, 1999. Under the Joyce rule, sales are thrown back to the state of origin if the selling corporation is not taxable in the destination state.

In addition to the sales factor rules provided by CCR §§25134 to 25136, the following rules apply to the sales factor denominator:

<table>
<thead>
<tr>
<th>CCR Section 25137-4.1</th>
<th>CCR Section 25137-4.2</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Inc. Years Beg. Before 1/1/96)</td>
<td>(Inc. Years Beg. On/After 1/1/96)</td>
</tr>
</tbody>
</table>

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.
Include gross receipts from business income.  
Same as CCR Section 25137-4.1.

Include net taxable gain from sale of assets.  
Same as CCR Section 25137-4.1.

Include gross receipts from federal funds sold.  
Include gross receipts net of interest expense on federal funds purchased.

Include net taxable gain on resale agreements  
Include net of repurchase agreements sold.

Include net taxable gain from trading activities.  
Include net of amounts paid including amounts paid in lieu of dividends, interest, etc.

Include net taxable gain from sale of loans.  
Include net taxable gain.  This includes income recorded for coupon stripping (IRC Section 1268).

The following rules apply to the sales factor numerator:

Interest income from loans is assigned to where the customer applied for the loan or where recognized by banking authorities.  
Interest income from loans secured by real estate is assigned to where the property is located.  Interest income from unsecured loans is assigned to where the borrower is located.

Leasing revenue is assigned to t/p's commercial domicile unless property is located in another state for the entire year and t/p is taxable in that state.  
Leasing income is assigned to where property is located except:
a. Transportation property assigned generally where used except for aircraft and motor vehicles.
b. Aircraft assigned by % of landings.
c. Motor vehicles assigned where registered.

Interest from participation loans is assigned to office that entered into the transaction.  
Same as interest income above.
<table>
<thead>
<tr>
<th>Income Source</th>
<th>Assignment/Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest from loans solicited by traveling officers</td>
<td>Same as interest income above.</td>
</tr>
<tr>
<td>Interest from loans solicited by traveling officers</td>
<td>Same as interest income above.</td>
</tr>
<tr>
<td>Credit card income is assigned to where credit card holder resides.</td>
<td>Assign to where the credit card holder resides.</td>
</tr>
<tr>
<td>Merchant discount on credit cards is assigned to where the merchant is</td>
<td>Assign to commercial domicile of merchant.</td>
</tr>
<tr>
<td>located. If t/p not taxable there, then assign to t/p's commercial domicile.</td>
<td></td>
</tr>
<tr>
<td>Fiduciary service income is assigned to where services are performed.</td>
<td>Same as CCR Section 25137-4.1</td>
</tr>
<tr>
<td>Income from traveler's checks and money orders is assigned to office that</td>
<td>Not discussed.</td>
</tr>
<tr>
<td>issued instrument.</td>
<td></td>
</tr>
<tr>
<td>Investment income (interest, dividends, &amp; net gain) is assigned to commercial</td>
<td>Assign based upon % of average value of these assets in this state to total</td>
</tr>
<tr>
<td>domicile or business situs.</td>
<td>average value of these assets. In lieu of the above method, t/p may elect (or</td>
</tr>
<tr>
<td></td>
<td>FTB may require) the following: % of this income properly assigned to a regular</td>
</tr>
<tr>
<td></td>
<td>place of business in this state to total of this income.</td>
</tr>
<tr>
<td>Interest from federal funds sold and purchased, securities purchased under</td>
<td>Same as investment income, above.</td>
</tr>
<tr>
<td>resale agreements, and securities sold under repurchase agreements is</td>
<td></td>
</tr>
<tr>
<td>assigned where recognized by banking authorities.</td>
<td></td>
</tr>
</tbody>
</table>
Trading assets and activities are assigned by the income producing activity.

Sale of tangible personal property is assigned to the destination.

Sale of other than tangible personal property is assigned by the income producing activity.

Throwback income to commercial domicile if t/p is not taxable in the state where the income is first assigned.

Regulation Section 25137-4.2(c)(3)(L) Investment Assets and Activities and Trading Assets and Activities
1. General rule for interest, dividends, net gains (cannot be less than zero), investment assets and activities from trading assets.
   a. Investment income (interest, dividends, net gains, & investment assets); federal funds sold, resale and repurchase agreements; and trading assets and activities are attributable to this state based upon % of average value of these assets per special apportionment rules contained in the regulation.
   b. Average value is determined under the rules of R&TC Sections 25130, 25131, and CCR Section 25137, as modified by the in lieu method discussed below.
2. In lieu of general rule 1 above, taxpayer's can use the following method.
   a. Investment income (interest, dividends, net gains, & investment assets), % based upon proper assignment to a regular place of business in this state to total of such income
   b. Federal funds sold, resale and repurchase agreements, % based upon proper assignment to a regular place of business in this state to total of such income
   c. Trading assets and activities, % based upon proper assignment to a regular place of business in this state to total of such income
3. If taxpayer elects to use the in lieu method it must continue to use this method in all subsequent returns
4. Proof of proper assignment, burden of proof is on taxpayer to prove day-to-day decisions regarding these assets occurred out of state.

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1065 AUDIT TECHNIQUES—REVIEW OF THE SALES FACTOR

The following audit steps concerning the sales factor are suggested.

Obtain the work papers used to develop the sales factor. Ask the taxpayer to fully explain how the work papers were developed. What was the source of the taxpayer's information?

Reconcile total sales per schedule R to the federal 1120. The taxpayer should not use the annual report sales if there are substantial differences in accounting methods between the books and the tax return, for example, operating leases vs. capital leases or differences in recognition of loan fees.

Insure that the taxpayer includes net gains on asset sales in the factor. It would be incorrect to use gross receipts per CCR Section 25137-4.1(a)(1) and CCR Section 25137-4.2(c)(2)(A).

Net gains means netting gains and losses from asset sales of each entity. Thus it would not be correct to only include gains in the factor. If the net of gains and losses result in a negative amount, the correct amount for factor purposes is zero.

Net gains for factor purposes are computed on an entity-by-entity basis. One affiliate's net loss on sale of assets would not reduce another affiliate's net gain.

Review the financial entity's operations in general so that you can develop audit steps for the numerator. For example, some financial corporations have incorporated each branch for limited liability reasons. Each subsidiary is most likely 100% inside or outside of the state.

If the taxpayer has several branches, determine how the taxpayer has accumulated sales factor information for the numerator. For example, are loans originated at each branch booked to that branch under normal accounting procedures?

In reviewing the taxpayer's information, look for large exceptions. For example, if the taxpayer is not reporting a reasonable amount of loan participation receipts, the auditor may want to review the underlying agreements to insure the regulation is correctly followed.

The auditor may only want to review large participation agreements to insure that the sales factor is correctly reported, depending on how material the item is.

Determine if the bank or financial corporation was a lessor of tangible personal property. If the commercial domicile of the taxpayer is within California, then under CCR Section 25137-4.1 all lease receipts will be included in the numerator, unless:
The property was outside the state for the entire year, and the bank or financial corporation is taxable in the other state or states. Past administrative practice has been to require a tax return as evidence of taxability. For example, assume a California commercial domiciled bank leases aircraft to a major airline. The bank does not include the lease payments in taxable income of any other state. The auditor would adjust the tax return, if necessary, to include the lease payments in the numerator.

If the bank or financial corporation does not have a California commercial domicile, then the auditor must prove that the property was located within California to include a portion of the lease receipts in the numerator. The auditor should also look to see that the leased property was outside the state of domicile for the entire year.

CCR Section 25137-4.1 was developed from the premise that a bank was historically not taxable outside their state of commercial domicile. Traditionally Congress opposed interstate banking. This was reflected in state law, R&TC Section 23181 which prior to 1986 provided that banks were only taxable if located within this state. No such limitations are placed on financial corporations.

As discussed in the introduction section of this guidebook, recent developments have opened interstate banking. In 1987, R&TC Section 23181 amended the test of nexus from "located within this state" to "doing business."

"Shell Office" Loans—Under CCR Section 25137-4.1 and Appeal of Crocker, SBE, 11/19/86, loans could be assigned to a shell office if they were "recognized by appropriate banking regulatory authority". Effective 1/1/96, CCR Section 25137-4.2 does NOT contain any wording regarding appropriate banking regulatory authority. It does state that the numerator of the sales factor includes loans not secured by real estate. Interest and fees, or penalties in the nature of interest from loans secured by real property, if the borrower is located in this state, is included. It also contains a throwback rule that states "All receipts which would be assigned under this section to a state in which the taxpayer is not taxable shall be included in the numerator of the receipts factor, if the taxpayer's commercial domicile is in this state." Therefore, effective 1/1/96, receipts cannot be assigned to a shell office.
1100 REFERENCE INDEX

Bank & Financial Handbook Section 1105 - BANK AND CORPORATION TAX LAW AND INTERNAL REVENUE CODE SECTIONS APPLICABLE TO BANKS, FINANCIALS AND SAVINGS & LOAN ASSOCIATIONS
Bank & Financial Handbook Section 1110 – INDEX OF BANK (B) AND S & L RELATED REVENUE RULINGS
Bank & Financial Handbook Section 1115 – INDEX OF BANK & S & L RELATED IRS NATIONAL OFFICE TECHNICAL ADVICE MEMORANDA (PRIVATE LETTER RULINGS)
Bank & Financial Handbook Section 1120 – REFERENCE INDEX-REFERENCE TO PUBLICATIONS
Bank & Financial Handbook Section 1125 - INDEX TO CASE LAW

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1105  BANK AND CORPORATION TAX LAW AND INTERNAL REVENUE CODE
SECTIONS APPLICABLE TO BANKS, FINANCIALS AND SAVINGS & LOAN
ASSOCIATIONS

<table>
<thead>
<tr>
<th>BCTL LAW Section</th>
<th>IRC CODE Section</th>
<th>DESCRIPTION</th>
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<td>23039</td>
<td>581</td>
<td>Definition of a Bank</td>
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<tr>
<td>24348</td>
<td>582</td>
<td>Bad debts, Losses and Gains with respect to Securities held by financial institutions.</td>
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<td>Reserves for Losses on Bad Debts</td>
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<td>24348.5</td>
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<td></td>
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<td>Securitizing Loans</td>
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<td>24322</td>
<td>597</td>
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</tr>
</tbody>
</table>
### 1110 INDEX OF BANK (B) AND S & L RELATED REVENUE RULINGS

The following summary of revenue rulings is provided only to assist you in research. The list is by no means complete nor will the rulings cited in each case be totally applicable for state purposes.

<table>
<thead>
<tr>
<th>Ruling Topic</th>
<th>Description</th>
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<tbody>
<tr>
<td><strong>Rev. Rul. 69-6</strong></td>
<td>Acquisition of a state chartered S&amp;L by a federally chartered S&amp;L is not a tax free reorganization</td>
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<td><strong>Rev. Rul. 75-213</strong> (IRC Section 582)</td>
<td>Bad debt, losses, and gains with respect to securities held by financial institutions</td>
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<td><strong>Rev. Rul. 84-94</strong> (IRC Section 585)</td>
<td>Bad debts; allocated transfer risk reserve</td>
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<td><strong>Rev. Rul. 80-270</strong></td>
<td>Bad debts reserves; Banks; additions; Section 351 transfer of loans</td>
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<td><strong>Rev. Rul. 79-214</strong></td>
<td>Bad debts; banks; reserves; classified by FDIC examiner</td>
</tr>
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<td><strong>Rev. Rul. 77-215</strong></td>
<td>Bank; theft losses; check kiting scheme</td>
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<tr>
<td><strong>Rev. Rul. 76-430</strong></td>
<td>Bad debt reserve; loans made by banks to affiliated corporations</td>
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</tbody>
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**Rev. Rul. 76-245**  
*Cumulative Bulletin* 1976-1  
**Ruling Topic**  
Bad debt reserves; banks; financial conformity

**Rev. Rul. 75-372**  
*Cumulative Bulletin* 1975-2  
**Ruling Topic**  
Bad debt reserves; additions; included loans

**Rev. Rul. 75-445**  
*Cumulative Bulletin* 1975-2  
**Ruling Topic**  
Bad debt reserve-change in method of computing addition to reserve

**Rev. Rul. 75-560**  
*Cumulative Bulletin* 1975-2  
**Ruling Topic**  
Addition to correct error

**Rev. Rul. 79-217**  
*Cumulative Bulletin* 1979-2  
**Ruling Topic**  
Bad debt reserve; building & loan association

**Rev. Rul. 79-123**  
*Cumulative Bulletin* 1979-1  
**Ruling Topic**  
Bad debt reserves; change in method; building & loan association

**Rev. Rul. 78-226**  
*Cumulative Bulletin* 1978-1  
**Ruling Topic**  
Bad debt reserves- record keeping requirements of building & loan associations

**Rev. Rul. 78-407**  
*Cumulative Bulletin* 1978-2  
**Ruling Topic**  
Bad debt reserves-mutual savings banks; bad debts; FDHA notes
Rev. Rul. 75-422  
Cumulative Bulletin 1975-2  
Ruling Topic  
Bad debt reserve; bank's warehoused mortgages

Rev. Rul. 75-140  
Cumulative Bulletin 1975-1  
Ruling Topic  
Mutual savings bank's accrued interest receivable, reserve for losses on loans

Rev. Rul. 75-548  
Cumulative Bulletin 1974-2  
Ruling Topic  
Bad debt reserves; mutual savings bank; mortgage escrow deposits

Rev. Rul. 72-170  
Rev. Rul. 71-333  
Ruling Topic  
Bad debt reserves; losses on loans

Rev. Rul. 76-362 (IRC Section 166)  
Cumulative Bulletin 1976-2  
Ruling Topic  
Bad debt reserves; Black Motor Car Formula

Rev. Rul. 54-193  
Cumulative Bulletin 1954-1  
Ruling Topic  
Conversion from a federal S&L into a building association is a tax free re-organization

Rev. Rul. 78-40  
Cumulative Bulletin 1978-1  
Ruling Topic  
Credit card service fees; cash method bank

Rev. Rul. 70-121  
Cumulative Bulletin 1970-1  
Ruling Topic  
Dividends credited to stock accounts by a building & loan association

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.
Rev. Rul. 84-10 (Section 595)
Cumulative Bulletin 1984-1
Ruling Topic
Exchange of mortgage backed certificates-residential mortgage pool—bank and S&L

Rev. Rul. 78-11
Ruling Topic
Exchange of Farmers Home Administration Insurance Contracts for Certificates. No gain or loss. S&L

Rev. Rul. 81-203
Cumulative Bulletin 1981-2
Ruling Topic
FHLMC participation certificates; pledged account mortgages

Rev. Rul. 80-96
Cumulative Bulletin 1980-1
Ruling Topic
FHLMC participation certificates

Rev. Rul. 75-251 (IRC Section 595)
Cumulative Bulletin 1975-1
Ruling Topic
Foreclosure; interest income on building and loan association's sale of foreclosed property

Rev. Rul. 72-237
Cumulative Bulletin 1972-1
Ruling Topic
Foreclosure on property; securing loans

Rev. Rul. 72-238 (IRC Section 166)
Cumulative Bulletin 1972-1
Ruling Topic
Foreclosure; gain realized in a proceeding by a creditor bank

Rev. Rul. 74-159 (IRC Section 1221)
Cumulative Bulletin 1974-1
Ruling Topic
Foreclosure; real estate acquired by a bank through foreclosure

Rev. Rul. 81-142
Cumulative Bulletin 1981-1

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.
Ruling Topic
Interest paid; credited to savings banks on magnetic tape

Rev. Rul. 80-157
Cumulative Bulletin 1980-1
Ruling Topic
Interest; un-matured savings certificates

Rev. Rul. 72-524
Cumulative Bulletin 1972-2
Ruling Topic
Interest computed for a period prior to the merger of a stock S&L

Rev. Rul. 69-3 (IRC Section 368)
Cumulative Bulletin 1969-3
Ruling Topic
Merger of two mutual S&Ls qualified as a reorganization

Rev. Rul. 79-72
Cumulative Bulletin 1979-1
Ruling Topic
Non-negotiable time deposit certificates; term overlap end taxable year

Rev. Rul. 74-221
Cumulative Bulletin 1974-1
Ruling Topic
PC’S; F.H.L.M.C. participation certificates

Rev. Rul. 74-169
Cumulative Bulletin 1974-1
Ruling Topic
PC’S; mortgage pool; mortgage backed certificates; S&L associations

Rev. Rul. 72-376
Cumulative Bulletin 1972-2
Ruling Topic
PC’S; Mortgage participation certificates

Rev. Rul. 69-188
Rev. Rul. 69-582
Ruling Topic
"Points" are interest

Rev. Rul. 83-60 (IRC Section 91)
Cumulative Bulletin 1983-1
Ruling Topic
Premature withdrawal penalties, discharge of indebtedness

Rev. Rul. 58-225
Cumulative Bulletin 1958-1
Ruling Topic
Prepaid interest paid to an accrual basis taxpayer is income in the year paid.

Rev. Rul. 73-116
Cumulative Bulletin 1973-1
Ruling Topic
REO-costs of disposing must be charged against the bad debt reserve

Rev. Rul. 74-371 (IRC Section 162)
Cumulative Bulletin 1974-2
Ruling Topic
Accounting for Secondary Reserve Transfers

Rev. Rul. 79-198
Cumulative Bulletin 1979-1
Ruling Topic
Stock dividend-building & loan assn.; charge to adjustment account

Rev. Rul. 70-540 (IRC Section 451)
Cumulative Bulletin 1970-2
Ruling Topic
Taxable year in which lending institutions are to include items in income

Rev. Rul. 77-128
Cumulative Bulletin 1977-1
Ruling Topic
Write-down of subsidiary's assets; charge to tax adjustment account—S&L
INDEX OF BANK AND S&L RELATED IRS NATIONAL OFFICE TECHNICAL ADVICE MEMORANDA (PRIVATE LETTER RULINGS)

The following Private Letter Rulings and Technical Advice Memorandums are provided to aid you in research of particular subjects. The list should not be considered as a complete summary of all articles on a particular subject. Furthermore, private letter rulings cannot be cited as authority. They should be used only to understand the logic or reasoning that applied to a particular set of facts.

**Ruling:** PTR 8136030  
**Code Section:** IRC Section 595  
**Year:** 1981  
**Topic:** Legal, appraisal & maintenance fees

**Ruling:** PTR 8011002  
**Code Section:** IRC Section 585  
**Year:** 1980  
**Topic:** Additions to reserve

**Ruling:** PTR 7803004  
**Code Section:** IRC Section 593  
**Year:** 1977-79  
**Topic:** Bookkeeping requirements

**Ruling:** PTR 8416030  
**Code Section:** IRC Section 593  
**Topic:** Carryover of bad debts on bank conversion

**Ruling:** PTR 8415014  
**Topic:** Creation of liquidation account in savings and loan conversion

**Ruling:** PTR 7943021 & PTR 7945011  
**Code Section:** IRC Section 585  
**Year:** 1977-79  
**Topic:**
Extraordinary losses

**Ruling:** PTR 8225006
**Topic:**
Fixed Dollar Reverse Purchase Agreement (simultaneous sale and repurchase of certificates); gain or loss on NMA certificates not an allowable loss

**Ruling:** PTR 7832010
**Code Section:** IRC Section 595
**Year:** 1977-79
**Topic:**
F.H.A insurance proceeds

**Ruling:** PTR 7926006 & PTR 8135030
**Topic:**
Loan Fees-when included in income

**Ruling:** PTR 8417078
**Topic:**
Mortgage pools

**Ruling:** PTR 8422009
**Topic:**
Mortgage pools—determination of amount of recognition of gain or loss. No gain or loss on concurrent sale/purchase.

**Ruling:** PTR 8422004
**Code Section:**
**Year:**
**Topic:**
Mortgage pools—amount of recognition of gain or loss (participation transaction). No allowable loss.

**Ruling:** PTR 8347008, PTR 8347006 & PTR 8347005
**Code Section:**
**Year:**
**Topic:**
Mortgage pools-amount and recognition of gain or loss

**Ruling:** PTR 8010012
**Topic:**
Mortgage Participation Interests; recognition of gain or loss. No loss.

**Ruling:** PTR 8006010  
**Topic:**  
Mortgage participation interests—sale of. No loss.

**Ruling:** PTR 8327008  
**Topic:**  
Mortgage participation certificates—exchange of mortgage for (with FHLMC)

**Ruling:** PTR 8342005  
**Topic:**  
Participation certificates—amount and recognition of gain or loss

**Ruling:** PTR 8538004  
**Topic:**  
Straddle transaction—sold GNMA's & FHLMC PC's; purchased GNMA's within 1 week. No loss allowed.

**Ruling:** PTR 7921016  
**Code Section:** IRC Section 585  
**Year:** 1977-79  
**Topic:**  
Write-down of bonds
1120 REFERENCE INDEX—REFERENCE TO PUBLICATIONS

"CCH TOPICAL INDEX TO PRIVATE LETTER RULINGS" - A guide listing by subject all private letter rulings available in law libraries, public libraries, etc.

"TAXATION OF FINANCIAL INSTITUTIONS-PEAT MARWICK MITCHELL & CO.", PUBLISHED BY MATHEW BENDER & CO. - A treatise on tax laws pertaining to financial institutions-3 volumes.

"FEDERAL INCOME TAXATION OF BANKS AND FINANCIAL INSTITUTIONS", PUBLISHED BY WARREN, GORHAM AND LAMONT - One volume discussion of tax issues.

"FEDERAL FINANCIAL INSTITUTIONS EXAMINATION COUNCIL - INSTRUCTIONS FOR CONSOLIDATED REPORTS OF CONDITION AND INCOME" (CALL REPORTS) – PUBLISHED BY THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM. Instructions for preparation of the regulatory reports required by the Federal Reserve. It is an excellent source for additional information on terminology as well as complete explanations of regulatory accounting principles and standards.

"MOODY’S BANK AND FINANCIAL MANUAL" - Financial information is provided for U.S. and foreign publicly held financial institutions.
INDEX TO CASE LAW

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Bad Charge-Off under Regulatory Order:
- Appeal of Foothill Bank (SBE) June 27, 1984
- Appeal of Center State Bank (SBE) April 7, 1987

Bad Debt Reserve-Foreclosures:

Bad Debt Reserve-Losses not allowed:
- Riverside Savings and Loan Association, (SBE) Vol. 21, pg.372

Bad Debt Reserve-Mergers:
- Appeal of People's Federal Savings and Loan Assn., (SBE) 2/6/73

Bad Debt Reserve-Negative Balance:
- Appeal of San Fernando Valley Federal Savings and Loan (SBE) 3/18/75

Bad Debt Reserve-Recapture:
- Home Savings and Loan Association v. U.S., U.S. Court of Appeals 4/16/75

Bad Debt Reserve-Retroactive Additions:
- Appeal of Culver Federal Savings and Loan Association (SBE) 2/14/66

Branch Application Costs:
- Central Texas Savings & Loan Association v. U.S., 731 F2d. 1181

Capitalized Costs:
- INDOPCO, Inc., Petitioner v. Commissioner of the Internal Revenue, 92-1 USTC 50,113

Core Deposits:
- Colorado National Bankshares, Inc. v. Com., (1990) 60 T.C.M. 771
- Banc One (84 TC 476) Dec. 41,985

Credit Unions—Non-Member Income:
- Appeal of Midcities Schools Credit Union (SBE) 12/15/66

Definition of Financial Corporations:
- Crown Finance Corporation vs. McColgan, 23 Cal. 2nd 280 (1943)
- The Morris Plan Co. vs. Johnson, 37 Cal. app. 2nd. 621 (940)

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.
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1200 AUDIT WORK AIDS

Exhibit A - Savings & Loan Association Industry Bad Debt
Exhibit B - Bank Industry Bad Debt Ratios
Exhibit C - Tax Rates
Exhibit D - Bank Bad Debt Computer Master Audit Schedule
Exhibit E - Savings and Loan Association Bad Debt Computer Master Audit Schedule
EXHIBIT A  SAVINGS & LOAN ASSOCIATION INDUSTRY BAD DEBT

This section is provided for historical reference only. CCR Section 24348(b) is repealed and is not applicable for taxable years beginning on or after January 1, 2002. The use of the reserve method of accounting for bad debts by banks and savings & loans is severely limited by IRC Section 585 to “small banks” as defined in IRC Section 585(c). Financials are no longer allowed to use the reserve method of accounting for bad debts. For an explanation of the current rules regarding the deduction for bad debts for banks and savings & loans, see Bank & Financial Handbook Section 0504, PROVISION FOR BAD DEBTS—FEDERAL AND CALIFORNIA METHOD.

<table>
<thead>
<tr>
<th>Year</th>
<th>Eligible Loan Base (000) OMITTED</th>
<th>Net Charge Offs</th>
<th>Ratio %</th>
</tr>
</thead>
<tbody>
<tr>
<td>1981</td>
<td>113,772,259</td>
<td>(2,506)</td>
<td>(0.00220)</td>
</tr>
<tr>
<td>1982</td>
<td>124,502,665</td>
<td>(1,368)</td>
<td>(0.00110)</td>
</tr>
<tr>
<td>1983</td>
<td>120,022,511</td>
<td>5,597</td>
<td>0.00470</td>
</tr>
<tr>
<td>1984</td>
<td>137,990,673</td>
<td>30,439</td>
<td>0.02210</td>
</tr>
<tr>
<td>1985</td>
<td>185,141,933</td>
<td>200,757</td>
<td>0.10840</td>
</tr>
<tr>
<td>1986</td>
<td>212,386,606</td>
<td>528,694</td>
<td>0.24893</td>
</tr>
<tr>
<td>1987</td>
<td>229,838,607</td>
<td>954,061</td>
<td>0.41510</td>
</tr>
<tr>
<td>1988</td>
<td>202,169,733</td>
<td>525,825</td>
<td>0.26009</td>
</tr>
<tr>
<td>1989</td>
<td>243,406,282</td>
<td>889,259</td>
<td>0.36534</td>
</tr>
<tr>
<td>1990</td>
<td>165,081,486</td>
<td>911,457</td>
<td>0.55213</td>
</tr>
<tr>
<td>1991</td>
<td>171,193,078</td>
<td>1,637,140</td>
<td>0.95630</td>
</tr>
<tr>
<td>1992</td>
<td>113,185,884</td>
<td>2,194,156</td>
<td>1.93850</td>
</tr>
<tr>
<td>1993</td>
<td>146,653,499</td>
<td>2,572,722</td>
<td>1.75430</td>
</tr>
<tr>
<td>1994</td>
<td>136,776,255</td>
<td>1,541,431</td>
<td>1.12698</td>
</tr>
<tr>
<td>1995</td>
<td>113,364,583</td>
<td>696,966</td>
<td>0.61480</td>
</tr>
<tr>
<td>1996</td>
<td>62,440,338</td>
<td>363,600</td>
<td>0.58232</td>
</tr>
<tr>
<td>1997</td>
<td>56,878,203</td>
<td>163,830</td>
<td>0.28804</td>
</tr>
<tr>
<td>1998</td>
<td>10,703,780</td>
<td>201,215</td>
<td>1.87985</td>
</tr>
</tbody>
</table>
EXHIBIT B  BANK INDUSTRY BAD DEBT RATIOS

This section is provided for historical reference only. CCR Section 24348(b) is repealed and is not applicable for taxable years beginning on or after January 1, 2002. The use of the reserve method of accounting for bad debts by banks and savings & loans is severely limited by IRC Section 585 to "small banks" as defined in IRC Section 585(c). Financials are no longer allowed to use the reserve method of accounting for bad debts. For an explanation of the current rules regarding the deduction for bad debts for banks and savings & loans, see Bank & Financial Handbook Section 0504, PROVISION FOR BAD DEBTSA—FEDERAL AND CALIFORNIA METHOD.

FROM THE FEDERAL RESERVE

<table>
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<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than $50 million</td>
<td>0.61%</td>
<td>0.49%</td>
<td>0.46%</td>
<td>0.88%</td>
<td>1.04%</td>
<td>1.21%</td>
<td>0.988%</td>
</tr>
<tr>
<td>$50 million to $100 million</td>
<td>0.62%</td>
<td>0.41%</td>
<td>0.26%</td>
<td>0.57%</td>
<td>1.01%</td>
<td>1.46%</td>
<td>1.026%</td>
</tr>
<tr>
<td>$100 million to $1 billion</td>
<td>0.62%</td>
<td>0.45%</td>
<td>0.43%</td>
<td>0.83%</td>
<td>1.39%</td>
<td>1.38%</td>
<td>1.159%</td>
</tr>
<tr>
<td>over $1 billion</td>
<td>1.19%</td>
<td>1.07%</td>
<td>1.23%</td>
<td></td>
<td></td>
<td></td>
<td>0.563%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than $50 million</td>
<td>1.013%</td>
<td>0.276%</td>
<td>0.366%</td>
<td>1.955%</td>
<td>6.774%</td>
<td>0.329%</td>
</tr>
<tr>
<td>$50 million to $100 million</td>
<td>0.693%</td>
<td>0.476%</td>
<td>0.322%</td>
<td>0.436%</td>
<td>0.251%</td>
<td>0.269%</td>
</tr>
<tr>
<td>$100 million to $1 billion</td>
<td>0.817%</td>
<td>0.458%</td>
<td>0.396%</td>
<td>0.294%</td>
<td>0.306%</td>
<td>0.542%</td>
</tr>
<tr>
<td>over $1 billion</td>
<td>0.447%</td>
<td>0.664%</td>
<td>0.745%</td>
<td>0.741%</td>
<td>0.824%</td>
<td>0.840%</td>
</tr>
</tbody>
</table>

The above ratios were obtained from the Federal Reserve Bank for the 12th District. CCR Section 24348(b)(3)(E) provides that the loan loss experience of California Banks of comparable size as published by the 12th Federal Reserve District may be deemed the industry-wide average.
## EXHIBIT C  TAX RATES

Financial Tax Rates (in percentages)

<table>
<thead>
<tr>
<th>IYE</th>
<th>89</th>
<th>90-91</th>
<th>92</th>
<th>93</th>
<th>94</th>
<th>95</th>
<th>96</th>
<th>97</th>
<th>98-2002</th>
</tr>
</thead>
<tbody>
<tr>
<td>JAN</td>
<td>10.674</td>
<td>10.741</td>
<td>10.763</td>
<td>11.015</td>
<td>11.137</td>
<td>11.483</td>
<td>11.483</td>
<td>11.30</td>
<td>10.84</td>
</tr>
<tr>
<td>MAY</td>
<td>10.698</td>
<td>10.741</td>
<td>10.852</td>
<td>11.049</td>
<td>11.258</td>
<td>11.536</td>
<td>11.536</td>
<td>11.30</td>
<td>10.84</td>
</tr>
<tr>
<td>DEC</td>
<td>10.741</td>
<td>10.741</td>
<td>11.007</td>
<td>11.107</td>
<td>11.470</td>
<td>11.300</td>
<td>11.300</td>
<td>10.84</td>
<td>10.84</td>
</tr>
</tbody>
</table>
EXHIBIT D BANK BAD DEBT COMPUTER MASTER AUDIT SCHEDULE

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EXHIBIT E  SAVINGS & LOAN ASSOCIATION BAD DEBT COMPUTER MASTER AUDIT SCHEDULE

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