

CALIFORNIA FRANCHISE TAX BOARD

Legal Ruling No. 285

April 23, 1965

BANKS: BAD DEBT RESERVE EXISTING ON LIQUIDATION

Syllabus:

In September 1961, the Audit Section issued an assessment against A for the income year 1955. Included in the adjustments made therein was the inclusion in income of the reserve for bad debts. The explanation given for this adjustment was "To the extent that tax benefits were received, the Reserve for Bad Debts is includible in income for the last year that a bank or corporation is subject to the tax measured by income." A protests only this adjustment and as a basis of protest alleges that there is no provisions in the Revenue and Taxation Code that permits such adjustment.

A was a national bank organized and existing under the laws of the United States with its principal office in California. On December 7, 1956, all of the assets of A were sold to, and all liabilities assumed by B. A was then liquidated and its assets consisting principally of cash received from the sale of its assets, were distributed to its stockholder, the X Company. In accordance with Section 24348 of the Revenue and Taxation Code, A, in prior years, established the reserve method of treating bad debts, and has maintained proper reserve accounts for bad debts. For the year 1955, A claimed as a deduction in computing its taxable income the amount of \$9,000 as a reasonable addition to its reserve for bad debts. As of December 31, 1955, A had on its books a reserve for bad debts in the amount of \$80,000. The maximum bad debt reserve, computed under the formula approved by the Franchise Tax Board was \$97,000.

Inasmuch as the Audit Section is taxing banks on bad debt reserves on hand at the time of liquidation advise whether it may include this reserve as income in either the year of liquidation or the year prior to liquidation.

The position of the Audit Section which resulted in the deficiency was that the reserve was a bad debt reserve, which, because of the sale of the business, had lost its purpose so that the portion of the reserve which had originally conferred a tax benefit must be restored to income.

The reserve method of protection against bad debts which taxpayer chose under the authorization of Section 24348 of the Revenue and Taxation Code is an alternative to deductions at the time bad debts occur. When an uncollectible debt on which a deduction from gross income has been taken is substantially collected, the amount so collected is treated as income in the year when

received. (S. Rossin & Sons, Inc. v. Com'r., 113 Fed. 2d 652; Putnam National Bank v. Com'r., 50 Fed. 2d 158). The Tax Court consistently held that any balance in a reserve for bad debts is similarly to be restored to income in the year in which the need for it ceases. (Arcadia Savings and Loan Association v. Com'r., 34 TC 679; West Seattle National Bank v. Com'r., 33 TC 341 affd. 288 Fed. 2d 47; Geyer, Cornell & Newell, Inc. v. Com'r., 6 TC 96; Citizens Federal Savings & Loan Association v. U.S., 7 AFTR 2d 1548).

This is not a case of the appreciation of an asset realized at the time of sale. Rather the sale of the asset has freed a particular charge against capital which, having been derived from income, must be returned to income. Such a determination does not do violence to the meaning or purpose of Section 24348. (See Katcher, Liquidating Problems and Pitfalls, N.Y.U., 17th Inst. on Fed. Tax, 827 at 840 -- 1959.)

Section 24348 provides in part that there shall be allowed as a deduction, in the discretion of the Franchise Tax Board, a reasonable addition to a reserve for bad debts. As authorized by Section 24348 the Franchise Tax Board has issued rulings and regulations relating to the amount allowable as an addition to a reserve for bad debts. Such rulings and regulations, however, do not relate to the treatment of a bad debt reserve when the need for the reserve eases.

Since additions to a bad debt reserve reduce the amount of tax which otherwise would be due, any amount received from the sale or other disposition of receivables in excess of their net tax basis in the year the need for the reserve ceases is required to be included in the measure of tax for the last year taxpayer is subject to tax measured by or imposed upon net income to the extent that the amounts derived from such sale resulted in a tax benefit. As used herein the term "net tax basis" means the face value of accounts receivable when sold, less amounts which have been set aside as a reserve for bad debts.

The tax measured by the inclusion of such income shall not be subject to proration provided for in Section 23332 of the Revenue and Taxation Code. Likewise, this ruling shall not be applicable where the assets of a taxpayer are transferred to another taxpayer in a reorganization as defined in Section 24351, if the transferee taxpayer succeeds to and takes the amount of the transferee taxpayer's bad debt reserve into account.