



STATE OF CALIFORNIA
FRANCHISE TAX BOARD
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B. TIMOTHY GAGE
 Member

December 18, 2000

Chief Counsel Ruling
 20-0176

Re: *****

Dear *****:

***** , you requested a Chief Counsel Ruling regarding the procedure to determine the adjustments, if any, required by a change in method of accounting for bad debts for *****

 ***** . Your request has been assigned to me for a response.

ISSUE

Does Revenue Procedure 85-8, 1985-1 C.B. 495, apply to *****
 ***** , which have received permission from the staff of the Franchise Tax Board to change from the specific charge-off method of accounting for bad debts to the bad debt reserve method of accounting for bad debts?

FACTS

 ***** , submitted a request for a change in method of accounting, from the specific charge-off method to the bad debt reserve method of accounting for bad debts. This request asked that the change be effective for the income year ended ***** . ***** , staff of the Franchise Tax Board requested additional information, which ***** provided on ***** . ***** , staff of the Franchise Tax Board approved the request for a change in method of accounting for bad debts from the specific charge-off method to the reserve method for the income year ended ***** .

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Revenue and Taxation Code section 24348 allows a deduction for debts that become worthless within the income year. The deduction may be based on an amount not in excess of the part charged off within that income year or, in the case of a bank, savings and loan association or financial corporation, in the discretion of the Franchise Tax Board, a deduction for a reasonable addition to a reserve for bad debts. The method to determine the deduction for bad debts for banks and savings and loan associations, based on either the specific charge-off method or the reserve method of accounting for bad debts, is provided in California Code of Regulations, title 18, section 24348(b).

California Code of Regulations, title 18, subsection 24348(b)(4) describes the required adjustment for banks or savings and loan associations that change from the reserve to the specific charge-off method of accounting for bad debts, which requires that the balance in the reserve for bad debts account be included in income for the income year in which the change is made, unless otherwise agreed upon in writing by the taxpayer and Franchise Tax Board.

There is currently no guidance in the California Revenue and Taxation Code, California Code of Regulations, FTB Rulings or Notices, Internal Revenue Code, Treasury regulations, or other publications of the Internal Revenue Service which offers definitive guidance or direction with respect to an adjustment, if any, required by a change in method of accounting for bad debts, changing from the specific charge-off method to the bad debt reserve method for accounting for bad debts. The following is a review of authorities addressing this issue.

Legal Ruling Number 302, dated April 23, 1965, discussed California Code of Regulations, title 18, section 24348(a), but was withdrawn by Legal Ruling 98-1 because it was considered to be obsolete due to its reference to California Code of Regulations, title 18, section 24348(a), which was applicable for income years before January 1, 1972. Legal Ruling Number 302 discussed the number of years permitted for spreading the amount provided for future losses in the year of change from the specific charge-off method of accounting for bad debts to the reserve method of accounting for bad debts, concluding that it was permissible to fully allow the provision in the year of change.

Revenue Procedure 85-8 provided the Federal rules for an adjustment for banks or savings and loan associations that change from the specific charge-off method of accounting for bad debts to the reserve method of accounting for bad debts in accordance with Internal Revenue Code section 166(c). Revenue Procedure 97-37, 1997-2 C.B. 455, section 14.02, declared Revenue Procedure 85-8 to be obsolete. Revenue Procedure 85-8 was based on Internal Revenue Code section 166(c), which was repealed as part of the Tax Reform Act of 1986.

Revenue Procedure 85-8 provided for a negative Internal Revenue Code section 481 adjustment over a period of one to three years as the result of the change from the specific charge-off method of accounting for bad debts to the bad debt reserve method

of accounting for bad debts. California Revenue and Taxation Code section 24721 conforms to Internal Revenue Code section 481 by reference. Internal Revenue Code section 481 provides the adjustments required by a change of accounting method. The Internal Revenue Code section 481 adjustment prescribed by Revenue Procedure 85-8 is the amount determined by dividing total net losses on bad debts (bad debt losses less bad debt recoveries) for the 5 tax years preceding the tax year of change (or the number of years in existence if less than 5 years) by the sum of the amount of outstanding trade receivables at the close of those tax years used above, and then multiplying the amount of outstanding trade receivables at the close of the tax year preceding the year of change by the resulting decimal amount. (See Rev. Proc. 85-8, section 5.02(3).)

The appropriate period relevant for the Internal Revenue Code section 481(a) adjustment referred to in section 5.02 of Revenue Procedure 85-8 is generally determined as follows:

When the entire amount of the section 481(a) adjustment is attributable to the tax year immediately preceding the year of change (first preceding year), the total adjustment is to be taken into account in computing taxable income for the year of change. The amount attributable to the tax year immediately preceding the year of change is the difference in the amount of the adjustment determined under section 481(a) of the Code for the year of change and the amount of the adjustment that would have been required under section 481(a) if the change to the reserve method of accounting for bad debts had been made in the preceding year.

When the adjustment is not attributable to the tax year immediately preceding the year of change (first preceding year) and 67 percent or more of the amount of the section 481(a) adjustment is attributable to the 1-tax year period, 2-tax year period, or 3-tax year period immediately preceding the year of change, the highest percent attributable to the 1, 2, or 3-tax year period is to be taken into account ratably over a 3-tax year period beginning with the year of change. Any remaining balance will be taken into account ratably over an additional period equal to the remainder of the number of tax years the taxpayer has used the method of accounting that is being changed. However, the total adjustment period shall not exceed 6 tax years. This rule only applies if the taxpayer has used the method being changed for more than 3 tax years. If the specific charge-off method of accounting for bad debts has been used for no more than 4 tax years, 75 percent shall be substituted for 67 percent. An amount attributable to the 1, 2 or 3-tax year period is the difference in the amount of the adjustment determined under section 481(a) of the Code for the year of change and the amount that would have been required under section 481(a) if the change to the reserve method of accounting for bad debts had been made at the beginning of the preceding 1, 2, or 3-tax year

period.

In all other situations if the aforementioned rules do not apply, the total Internal Revenue Code section 481(a) adjustment is to be taken into account ratably over the number of tax years (not to exceed 6) the taxpayer has used the specific charge-off method of accounting.

California Revenue and Taxation Code section 24348 is based upon and is substantially similar to the former Internal Revenue Code section 166(c)¹. Consequently, federal precedent regarding Internal Revenue Code 166(c) is persuasive of the proper interpretation of section 24348, even though this Internal Revenue Code subsection has been repealed. (*Meanley v. McColgan* (1942) 49 Cal.App.2d 203.)

FTB Notice 89-277, May 10, 1989, provides, "Where the provisions of the Personal Income Tax Law and the Bank and Corporation Tax law are in substantial conformity with the Internal Revenue Code, the Franchise Tax Board will generally follow federal regulations, procedures and rulings."

FTB Notice 94-6, November 28, 1994, provides direction regarding the extent to which the Franchise Tax Board will follow the Internal Revenue Service and Revenue Procedure 92-20, 1992-1 C.B. 685, request for a change in method of accounting. The Notice concludes that the Franchise Tax Board will generally follow the Internal Revenue Service regarding permission to change a method of accounting.

ANALYSIS

California Code of Regulations, title 18, subsection 24348(b)(4) describes the required adjustment for banks or savings and loan associations that change from the reserve to the specific charge-off method of accounting for bad debts. This section indicates some flexibility in the timing of the required adjustment for a change in method of accounting for bad debts from specific-charge-off to bad debt reserve.

Legal Ruling 302 concluded that it was permissible to fully allow the provision in the year of change for spreading the amount provided for future losses from the specific charge-off method of accounting for bad debts to the reserve method of accounting for bad debts.

Revenue Procedure 85-8 provided for a negative Internal Revenue Code section 481 adjustment, generally over a period of one to three years, with a possibility of as much as six years, as the result of the change from the specific charge-off method to the bad debt reserve method of accounting for bad debts. There is specific guidance for the

¹ See *Appeal of Center State Bank*, 87-SBE-127; *Appeal of Dynatech Fluid technology Corporation* 87-SBE-028; *Appeal of Temple Hospital Corporation*, 87-SBE-060.)

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period of time for the adjustment, dependent on the amount of the adjustment attributable to the years immediately preceding the year of change.

CONCLUSION

Based upon review of all of the foregoing, and recognizing the taxpayer's need for guidance on this matter, the procedure provided in Revenue Procedure 85-8 to determine the adjustments required by the change in method of accounting for bad debts, from the specific charge-off method of accounting for bad debts to the bad debt reserve method of accounting for bad debts, is considered reasonable and is approved for use by *****.

Please be advised that the tax consequences expressed in this opinion are applicable to the named taxpayer only and are based upon and limited to the facts you have submitted. In the event of a change in relevant statutory or judicial or administrative case law, a change in federal interpretation of federal law in cases where our opinion is based upon interpretation, or a change in the material facts or circumstances relating to your request upon which this opinion is based, this opinion may no longer be applicable. It is your responsibility to be aware of these changes should they occur.

This letter is a legal ruling by the Franchise Tax Board Chief Counsel within the meaning of Revenue and Taxation Code section 21012(a)(1).

Very truly yours,

Edward J. Kline
Tax Counsel