



## FTB NOTICE

California Franchise Tax Board - Legal Branch

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February 20, 1998

### FTB NOTICE 98-3

#### **SUBJECT: S CORPORATIONS - CHANGE IN ACCOUNTING METHOD FROM BAD DEBT RESERVE FOR BANKS, SAVINGS AND LOAN ASSOCIATIONS, AND FINANCIAL CORPORATIONS**

During 1997, California enacted legislation amending the California Bank and Corporation Tax Law that impacts the tax status of corporations as S or C corporations. These legislative changes contain an effective date of January 1, 1997 even though the legislation was not enacted until late in the year. The Franchise Tax Board ("FTB") has identified two specific concerns involving S corporation status or elections for financial corporations that use the reserve method of accounting for bad debts.

One situation involves the termination of S corporation status for financial corporations that validly elected S corporation status under prior law but are not eligible S corporations under current law. The other situation involves the treatment of an S corporation election as an automatic election to change the corporation's accounting for bad debts from the reserve to specific charge-off method.

The purpose of this notice is to advise the public of the specific concerns and the result to a taxpayer if no action is taken. Also, this notice provides guidance for any financial institution that seeks to avoid the automatic results and maintain either S corporation status or the reserve method of accounting for bad debts.

## Discussion

### Situation 1

Prior to enactment of the Small Business Jobs Protection Act of 1996 ("SBJPA of 1996"), federal law defined ineligible corporations for S corporation status to include banks and savings and loan associations using the reserve method of accounting for bad debts. Although California conformed to the federal definition of ineligible corporations, California law recognizes financial corporations as another type of financial institution, in addition to banks and savings and loan associations. California Revenue and Taxation code (hereinafter R&TC) § 23183, California Code of Regulations, Title 18, section 23183. California tax law allows banks, savings and loan associations and financial corporations to report bad debts using the reserve method of accounting. R&TC § 24348. Therefore, under prior law, it was possible for a financial corporation electing federal S status to be a California S corporation even though using the reserve method of accounting for bad debts for California tax purposes.

As part of the SBJPA of 1996, the definition of ineligible corporation for S corporation status was amended to include financial institutions that use the reserve method of accounting for bad debts. Financial institutions that do not use the reserve method of accounting for bad debts are now eligible to elect S corporation status. California has conformed to this statutory change of definition for income years beginning on or after January 1, 1997. Although a financial corporation using the reserve method of accounting for bad debts for California tax purposes may have elected S corporation status under prior law, such corporation is an ineligible corporation for income years beginning on or after January 1, 1997. If a taxpayer in this situation does nothing, its S corporation status terminates as of the beginning of such income year and it will report income and pay tax on such income as a C corporation.

In order to avoid termination of S corporation status because of a change in the federal law to which California conformed in October 1997, a financial corporation may file an application to change its method of accounting for bad debts from the reserve method to the specific charge-off method for the first income year beginning on or after January 1, 1997.

To file an application to change its accounting method for the income year beginning in 1997 in accordance with this notice, the financial corporation should file a completed federal Form 3115, Application for Change in Accounting Method, with its California S Corporation Franchise or Income Tax Return (Form 100S) by the due date of the return, as extended. Pursuant to the authority granted in Treasury Regulation section 1.446-1(e)(3)(ii), the requirement to file an application for change in accounting method within 180 days after the beginning of the income year in which the taxpayer desires to make the change is waived. Consent to such

application to change will be deemed made by the Franchise Tax Board effective for income years beginning on or after January 1, 1997, if the application is made in accordance with this notice.

The change in accounting method for bad debts from the reserve method to specific charge-off requires an Internal Revenue Code (IRC) section 481(a) (RT&C § 24271) adjustment for the amount of the reserve for bad debts as of the close of the income year immediately preceding the year for which the change is to take effect. The section 481(a) adjustment shall be included in income ratably over a period the lesser of six years or the number of years that the financial corporation used the reserve method.

The procedure set forth in this notice shall be the exclusive procedure available to a financial corporation using the reserve method to account for bad debts to change its method of accounting and maintain its S corporation status for the income year beginning in 1997. Nothing in this notice shall be deemed a prohibition against verification by the Franchise Tax Board of the computation of the amount of the section 481(a) adjustment or confirmation that the financial corporation has fully complied with the terms of this notice.

The Form 3115, Application for Change in Accounting Method, should include the phrase "FILED PURSUANT TO FTB NOTICE 98-3" in red across the top of page 1 of the form.

#### Situation 2

Another change from the SBJPA of 1996 allows a financial institution (a term that includes banks and savings and loan associations) that does not use the reserve method of accounting for bad debts to elect S corporation status for taxable years beginning on or after January 1, 1997.

If a bank, savings and loan association, or financial corporation using the reserve method of accounting for bad debts files federal Form 2553 electing federal S corporation status, such election will be deemed to be an election by the corporation to change its method of accounting for bad debts to the specific charge-off method.

In 1997, the Internal Revenue Service announced procedures to permit certain financial institutions using the reserve method of accounting for bad debts to change their method of accounting for bad debts and become an S corporation. In accordance with Revenue Procedure 97-18, I.R.B. 1997-10, 53, a bank using the reserve method of accounting for bad debts that files federal Form 2553 to elect S corporation status is deemed to have elected to change its method of accounting for bad debts from the reserve method to the specific charge-off method effective for its taxable year beginning in 1997. The revenue procedure established the period over which the resulting IRC section 481(a) adjustment is

spread as the lesser of 6 years or the number of years the reserve method of accounting for bad debts was used.

In general, a federal tax election is binding for California tax purposes unless the taxpayer makes a different election with the FTB. R&TC §§ 23051.5(e) and (f). Therefore, the federal election to become an S corporation and the deemed election to change a corporation's method of accounting are effective for California tax purposes unless the corporation elects to remain a California C corporation. This California C corporation election must be made no later than the last day for making the federal S corporation election. R&TC § 23801(a)(4)(A)(ii).

Although the last date for making a C corporation election had passed before the 1997 legislation was enacted, special implementation provisions for 1997 were included in the amendments to the S corporation statutes. If a corporation that did not qualify as an S corporation under prior law made a valid federal election to be an S corporation between January 1, 1997, and the enactment date of the California amendments, the corporation will be treated as an S corporation for California tax purposes for its first income year beginning on or after January 1, 1997. R&TC § 23801(a)(5)(C). A corporation may timely elect to retain its C corporation status for California tax purposes within 180 days after the date of enactment of the legislation (i.e., by April 1, 1998) by filing a completed form FTB 3560, with the appropriate box checked.

### **Drafting Information**

The principal author of this notice is Kimberly Mitchell Bott of the Franchise Tax Board, Legal Branch. For further information regarding this ruling, contact Ms. Bott at the Franchise Tax Board, Legal Branch, P. O. Box 1720, Rancho Cordova, CA 95741-1720, (916) 845-3007.