

## **0500 STATE ADJUSTMENTS TO INCOME PER LINE 28 OF THE FEDERAL RETURN**

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. 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.

### **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 For taxable years beginning on or after 1/1/96, the federal bad debt provisions applicable to savings & loans were repealed.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 historic 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:

	<b>Eligible Loans*</b>	<b>Net Losses At Year End (Net of Recoveries)</b>
<b>1998</b>	\$300,000	\$4,000
<b>1999</b>	200,000	(3,000)
<b>2000</b>	100,000	5,500

<b>2001</b>	150,000	2,000
<b>2002</b>	200,000	3,500
<b>2003</b>	350,000	2,000
<b>Totals</b>	<b>\$1,300,000</b>	<b>\$14,000</b>

Six-Year Moving Average:

Bad Debt Loss Ratio:  $\$14,000/\$1,300,000 = 1.0769\%$

Allowable Reserve at Year End:  $\$350,000 \times 1.0769\% = \$3,769$

Beginning Reserve before Bad Debt Provision	\$5,000
Less net charge-offs in 2003	<u>2,000</u>
Bad Debt Reserve before Provision	<u>3,000</u>
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:

Balance of reserve for losses on	
Loans at base year end (December 31, 2002)	\$100,000
Less: Bad debts, net of recoveries	<u>(50,000)</u>
Deduction based on minimum reserve level	\$ 50,000

### 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:

<u>Loan reserve at base year</u>	X	Loans outstanding at
Loans outstanding at base year		Current year

\$100,000 X \$900,000 = \$90,000  
\$1,000,000

Based on the above facts, the deduction for the addition to the bad debt reserve is calculated as follows:

Balance of reserve for losses on  
Loans at base year end (December 31, 2002) \$90,000  
Less: Bad debts, net of recoveries (50,000)  
  
Deduction based on minimum reserve level \$40,000

\*\*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.

#### **0544 INTEREST EXPENSE ALLOCABLE TO TAX-EXEMPT OBLIGATIONS**

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. 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.

However, for franchise tax purposes all obligations are subject to tax, hence this section has no effect on banks and savings & loan associations subject to the franchise tax.

#### **0548 ACCOUNTING METHODS**

Bank & Financial Handbook Section 0548.1 – Cash Method of Accounting

Bank & Financial Handbook Section 0548.2 – Original Issue Discount

Bank & Financial Handbook Section 0548.3 – Change of Accounting Methods/Mergers

### **0548.1 Cash Basis Method of Accounting**

California conformed to IRC Section 448 (R&TC Section 24654) effective for income years beginning on or after January 1, 1987.

### **0548.2 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 0404, Methods of Treatment of Original Issue Discount.

### **0548.3 Change Of Accounting Method / Mergers**

See Bank & Financial Handbook Section 0424, 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 Tto 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 (beginning of year + end of year)/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 (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.