



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
PSG ENTERPRISES)

For Appellant: Martin Rich
Certified Public Accountant

For Respondent: James W. Hamilton
Acting Chief **Counsel**

Kendall E. Kinyon
Counsel

O P I N I O N

This appeal is made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of PSG Enterprises against a proposed assessment of additional franchise tax in the amount of \$2,334.08 for the income year ended April 30, 1971.

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From 1961 until 1970, appellant PSG Enterprises owned and operated a retail jewelry store in Santa Barbara, California. The store, which was managed by a **nonstockholder** employee, specialized in selling inexpensive jewelry on **credit**. Appellant's sister **corporation**, Swiss American Jewelers (hereinafter referred to as "Swiss"), supplied the inventory for the store.

Appellant apparently used an **accrual** method of accounting based on a fiscal year ending April 30th. For **federal income** and California franchise tax purposes, it also elected to use the reserve method of accounting for bad debts. The following is a table of the activity in appellant's bad debt reserve for the fiscal **years** immediately prior to the fiscal year in question:

<u>Fiscal year ended 4/30</u>	<u>Trade notes and accounts receivable at end of year</u>	<u>Amount added to reserve</u>	<u>Amount charged against reserve</u>	<u>Reserve at end of year</u>
1966.	43,096		-	4,379
1967	34,647	2,250	3,030	2,599
1968	42,935	1,530	909	3,220
1969	54,144	3,388	2,547	4,061
1970	56,231	3,632	3,476	4,217

Sometime in 1969 appellant's owners became aware that the jewelry store was in serious financial difficulty, and they therefore decided to sell the assets of the business. They found a buyer after some delay and the sale was completed on April 18, 1971, about two weeks before the end of appellant's 1971 fiscal year. The total sales price was **\$10,000.00**, of which \$200.00 was assigned to equipment and fixtures and **\$9,800.00** to accounts receivable. As of the date of the sale, appellant's books reflected accounts receivable of **\$45,274.97** with an offsetting reserve for bad debts of **\$3,572.45**. The books also revealed a **\$41,627.00 obligation** which appellant owed to Swiss.

Appellant charged off a **\$37,627.00 loss** against its bad debt reserve on its books for the 1971 fiscal year. Most of this amount appears to have **consisted of** an alleged loss on the sale of the accounts receivable. Appellant also

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credited the reserve in the amount of **\$37,297.00**, representing liabilities which appellant owed to Swiss but which Swiss had forgiven. Appellant then claimed a deduction on its franchise tax return for the difference between these two items, \$330.00, as an addition to its bad debt reserve. After an audit, respondent disallowed the attempt to charge off the **alleged loss** against the bad debt reserve. The question presented on appeal is whether this action was correct.

Appellant contends that the loss was a bona fide loss resulting from bad credit policies on the part of the store's manager. Respondent does not dispute this claim. Respondent contends, however, that during appellant's 1970 **fiscal** year appellant discovered or should have discovered that many of its accounts receivable were worthless. The worthless accounts should therefore have been charged against appellant's bad debt reserve in the 1970 fiscal year, respondent continues, and since they were not, the reserve at the beginning of the appeal year was insufficient to cover bad debts which appellant knew or should have known to exist at that time. **From** this respondent concludes that even if appellant suffered an economic loss on the sale, it was not entitled to make **an** addition to the reserve during the appeal year to account for that loss.

We agree with respondent that appellant could not claim a deduction for an addition to its bad debt reserve to account for the alleged loss on the sale of accounts receivable. This is because losses on the sale of accounts receivable are not bad debt losses, but rather are losses on the sale of property. (Bird Management, Inc., 48 **T.C.** 586, 595; John T. Dodson, 52 **T.C.** 544 559; Harold F. Brooks, 63 **T.C.** 1, 8.) Therefore, such losses are not chargeable against a-reserve for bad debts. (J. E. Hawes Corp., 44 **T.C.** 705, 709.)

It does not follow, however, that the loss was necessarily nondeductible during the appeal year, although respondent so contends under the authority of the Appeal of Peterson Lumber and Finance Co., decided by this board on **November 15, 1939**. In that case we held that the provisions of the **Personal** Income Tax Law authorizing a deduction for

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a reasonable allowance to a reserve for bad debts do "not permit a taxpayer, by making less than a reasonable allowance in one year, to justify a **correspondingly greater** allowance in a subsequent year." As explained in the **preceeding** paragraph, however, losses on the **sale** of accounts receivable are not bad debt losses. Whether the loss in question is deductible or not therefore depends, not on the provisions of the law dealing with bad debts, but on the provisions dealing with gains and losses on the sale or exchange of property, (John T. Dodson, supra.) Accordingly, Peterson Lumber, and other cases dealing with bad debt reserves are not controlling on this appeal.

Since appellant improperly attempted to charge off the alleged loss against its bad debt reserve, we sustain respondent's action in this regard. However; since the parties have not discussed the applicability of the statutory provisions governing losses **on** the sale of property, and since the record now before us is insufficient to permit a determination of this issue, the appellant *will* have an opportunity to establish its right **to a** loss deduction under those provisions by filing a timely petition for rehearing.

O R D E R

Pursuant to the views expressed in, the opinion of the board on file in this proceeding, and good cause appearing therefor,

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IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of PSG Enterprises against a proposed assessment of additional franchise tax in the amount of \$2,334.08 for the income year ended April 30, 1971, be and the same is hereby sustained.

Done at Sacramento, California, this 26th day of July, 1976, by the State Board of Equalization.

Stephen W. Zupardo, Chairman
George J. Jewell, Member
Richard H. ..., Member
_____, Member
_____, Member

ATTEST: *W.W. Dunlop*, Executive Secretary