



Appeal of Wright Way Mobile Homes, Inc.

The issue presented by this appeal is whether appellant may anticipate losses, caused by the prepayment of purchase money security agreements by its customers, by means of additions to a reserve for bad debts.

Appellant is an accrual basis taxpayer engaged in the sale of mobile homes. Appellant's sales are normally financed by purchase money security agreements, which are immediately discounted to a bank. The financial institution pays appellant the principal amount of the note and credits a portion of the finance charge (i.e., a "dealer differential") to a dealer reserve account. This latter amount is held in reserve by the bank as collateral for the performance on the promissory notes assigned to it. Upon receipt of the finance charges from appellant's customers, the bank releases this **holdback** to appellant. **Release** of the **holdback** is contingent upon receipt of the **finance** charge from the customer; If the customer prepays on the loan, **thereby** eliminating all or a portion of the finance charge, the bank makes an appropriate debit to appellant's reserve account.

Upon audit, respondent determined that the "dealer differential" constituted income which accrued to appellant upon assignment of a purchase money security agreement to a financial institution; the subject notices of proposed assessment were subsequently issued. Appellant protested on the grounds that there was no constructive receipt of the income due to the retention by the bank of that income in the reserve account. After due consideration of appellant's protest, respondent affirmed its proposed assessment, thereby resulting in this appeal.

Appellant now concedes that the doctrine of constructive receipt is inapplicable with respect to accrual basis taxpayers and acknowledges that the **holdbacks** discussed above constituted taxable income upon assignment of the promissory notes to the bank. Appellant argues, however, that the holdbacks were proper additions to a bad debt **reserve** pursuant to Revenue and Taxation Code section 24348, and that an addition to a bad debt reserve in an amount equal to the figure that the bank added to its dealer reserve, account constituted a reasonable addition. For the years in issue, appellant partially completed respondent's Schedule F "Bad Debts-Reserve Method."

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Respondent argues that appellant may not anticipate losses caused by the prepayment of purchase money security agreements by means of additions to a bad debt reserve. In the alternative, respondent contends that appellant was not eligible to use the reserve method for bad debts and that even if it were, its additions to that reserve were not reasonable. Our concurrence with the initial argument advanced by respondent obviates the need to discuss its alternative positions.

The issue presented by this appeal is identical to the one addressed by the United States Tax Court in Quality Chevrolet Co., 50 T.C. 458 (1968), affd., 415 F.2d 116 (10th Cir. 1969), cert. den., 397 U.S. 908 [25 L.Ed.2d 89] (1970), wherein the court held, in a factual setting substantively indistinguishable from that presented by the instant appeal, that the taxpayer's losses due to the prepayment of promissory notes were not losses due to the worthlessness of debts, and that a reserve for such anticipated losses is not recognized for tax purposes. Specifically, the tax court stated as follows:

The losses sustained by the petitioner as a result of the prepayment of the notes are not losses resulting from the worthlessness of a debt. A debt ~~becomes~~ <sup>is</sup> worthless within the meaning of section 166<sup>1/</sup> when it is uncollectible because the debtor is unwilling or unable to pay. However, the prepayment losses are not due to the debtor's unwillingness or inability to pay but occur because he chooses to satisfy the debts in advance of their maturity.

\* \* \*

We conclude that when the petitioner suffers a loss because of prepayment of a note by a customer, the loss is not a bad debt loss within the meaning of section 166. Consequently, the petitioner is not entitled to the

1/ In pertinent part, this section is the federal counterpart to Revenue and Taxation Code section 24348. Accordingly, federal case law is highly persuasive in interpreting the California statute. (Rihn v. Franchise Tax Board, 131 Cal.App.2d 356, 360 [280 P.2d 893] (1955).)

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special treatment provided by Congress in that section, but must deduct its loss under the general-rule of Brown v. Helvering [291 U.S. 193, 78 L.Ed. 725 (1934)]--in the year in which it occurs. (Quality Chevrolet Co., 50 T.C. 458, 465.) (Footnote added.)

The above authority is controlling of the issue presented here. Respondent's action in this matter will, therefore, be sustained.

