

BEFORE THE STATE BOARD OF EQUALIZATION  
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of )  
FOOTHILL BANK )

For Appellant: Stephen C. Schwarz

For Respondent: Charlotte A. Meisel  
Counsel

O P I N I O N

This appeal is made pursuant to section 26075, subdivision (a), of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claim of Foothill Bank for refund of franchise tax in the amount of \$13,718 for the income year 1979.

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The question presented by this appeal is whether appellant was entitled to make a retroactive addition to its 1979 bad debt reserve.

Appellant is a cash basis taxpayer that has elected the reserve method of accounting for its bad debts. On its franchise tax return for the income year 1979, filed January 31, 1980, appellant deducted an addition to its bad debt reserve of \$202,500. On January 2, 1980, the State Banking Department began an examination of appellant's loan portfolio.. That **agency determined** that appellant's bad debt reserve was inadequate and directed that it be increased. This increase was reflected in appellant's "Financial Statements and Auditor's Report," issued February 11, 1980, representing the bank's condition as of December 31, 1978, and December 31, 1979. On May 4, 1980, appellant filed an amended return for 1979, increasing the addition to its bad debt reserve by \$162,549 and claiming a refund attributable to the increased deduction. Respondent denied the refund, and this appeal followed.

Respondent contends that the refund was properly denied because it was based on an unallowable retroactive addition to appellant's bad debt reserve. It states that the \$162,549 should be considered as part of the addition to the bad debt reserve for the 1980 income year because it was in that year that the additional debts were determined to be worthless. Appellant argues that the amended return merely showed the correct amount of the bad debt reserve as of December 31, 1979. It points out that it was the mere physical act of charging off the debt which was done after the close of the year, but that the amount to be added to the reserve was determined based on conditions existing at the close of the income year.

The reserve method of accounting for bad debts is allowed, in the discretion of the Franchise Tax Board, by Revenue and Taxation Code section 24348, subdivision (a). The same provision is made in federal law by Internal Revenue Code section 166(c). Because of the discretion vested in the administering agency, the taxpayer's burden of proof is heavier than usual when attempting to overcome the presumption of correctness which attaches to respondent's determinations regarding bad debt reserves. Appellant must show both that its additions to the reserve were reasonable and that respondent's action in disallowing those additions was arbitrary and amounted to an abuse of its discretion. (Roanoke Vending Exchange, Inc., 40 T.C. 735, 741 (1963).) Since respondent has not contested the

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reasonableness of appellant's total addition, all that appellant need show is that respondent abused its discretion in disallowing the increased addition to the bad debt reserve.

A basic requirement for an addition to a bad debt reserve is that it reflect the conditions existing at the end of the income year. (Roanoke Vending Exchange, Inc., supra; former Cal. Admin. Code, tit. 18, reg. 24348(g), subd. (2)(A), repealer filed Sept. 3, 1982 (Register 82, No. 37); Treas. Reg. §1.166-4(b)(1); see also Cal. Admin. Code, tit. 18, reg. 24348(b), subd. (3)(A).) Therefore, a taxpayer may not rely on subsequent events, such as its actual loss experience in later years, to retroactively enlarge the addition to its bad debt reserve for an earlier year. (Farmville Oil & Fertilizer Co. v. Commissioner, 78 F.2d 83, 84-85 (4th Cir. 1935); Roanoke Vending Exchange, Inc., supra; Appeals of Leight Sales Co., Inc., and G. L. Company, Inc., Cal. St. Bd. of Equal., June 29, 1982.) A taxpayer must be allowed, of course, a reasonable time after the close of its income year to audit its books and adjust its entries accordingly, including the entries to its reserve accounts. (See Rio Grande Building & Loan Association, 36 T.C. 657, 664 (1961).)

The present case is clearly distinguishable from those cited by respondent in which retroactive additions were disallowed. This is not a case where later experience is used to retroactively increase the bad debt reserve, as in Farmville Oil & Fertilizer Co. v. Commissioner, supra, nor is it a case where, several years later, a taxpayer attempts to increase the reserve of a previous year because of earlier ignorance of the law, as in Rogan v. Commercial Discount Co., 149 F.2d 585 (9th Cir. 1945) and Rio Grande Building & Loan Association, supra.

Respondent's statement that "[t]hese debts were determined to be worthless in income year 1980 . . . . (Resp. Br. at 3) is ambiguous and misleading, True, the determination of their worthlessness was made in 1980, but they were determined to have been worthless as of December 31, 1979. The additional amount deducted on appellant's amended return was the same as that shown on its books and in its financial statements for income year 1979. It is the amount which the state banking authority determined it must include in its reserve for the income year 1979. It was only because appellant filed its original return before final adjustments were made to its books

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that the correct amount was not shown on its original return. It has not made a "retroactive addition" to its bad debt reserve merely by correcting the amount of the addition in an amended return. There is no indication that the amount deducted was unreasonable or determined in light of any facts other than those existing at the close of the income year of the proposed addition. We conclude, therefore, that respondent's disallowance of the increased addition to the bad debt reserve, and consequent denial of appellant's claim for refund was arbitrary and amounted to an abuse of its discretion. Respondent's action, therefore, must be reversed.

