

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
COMMONWEALTH FINANCIAL)
CORPORATION)

For Appellant: Susan L. Bloom

For Respondent: Paul Petrozzi
Counsel

O P I N I O N

This appeal is made pursuant to section 25666 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Commonwealth Financial Corporation against a proposed assessment of additional franchise tax in the amount of **\$11,294.07** for the income year 1977.

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The issue presented by this appeal is whether respondent abused its discretion in disallowing an addition to appellant's bad debt reserve for 1977.

Appellant, a commercial finance company, is engaged in the business of making high-interest loans to high-risk clientele, such as small businesses with minimal or negative net worth, which are unable to obtain conventional financing. Since its incorporation, appellant's outstanding loans increased from \$33,786 in 1969 to **\$7,897,150** in 1977.

Appellant is an **accrual-basis** taxpayer which has elected the **reserve** method of accounting for its bad debts. At the beginning of 1977, its bad debt reserve balance was **\$219,565**. On its franchise tax return for that **year**, appellant deducted \$106,238 as an addition to its bad debt reserve, bringing the balance to \$304,069, or 3.85 percent of appellant's outstanding receivables.

In the course of auditing appellant's return, respondent determined that the reserve existing at the beginning of the year was sufficient to **cover** those losses which, based on appellant's prior loss experience, could reasonably be anticipated to result from the debts outstanding at the end of the year. Respondent, therefore, issued a notice of proposed assessment reflecting the disallowance of the addition to appellant's bad debt reserve. Appellant protested, but after a hearing, respondent affirmed the assessment. Appellant then brought this appeal.

Revenue and Taxation Code section 24348, subdivision (a), states, in part: "There shall be allowed as a deduction debts which become worthless within the income year; or, in the discretion of the Franchise Tax Board, a reasonable addition to a reserve for bad debts." **[Emphasis added.]**

This section allows deductions for additions to a bad debt reserve only in the discretion of the Franchise Tax Board. Internal Revenue Code section **166(c)**, the federal counterpart to section 24348, grants the **Commissioner of Internal Revenue** the same discretion. It has been consistently held that the taxpayer bears the heavy burden of proving that respondent (or the Commissioner) abused its discretion in its determination of a "reasonable" addition; that is, the taxpayer **must show** not only that his computation is reasonable, but also that respondent's computation is unreasonable and

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arbitrary. (Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 547-548 [**58 L.Ed.2d 785**] (1979); Appeal of H-B Investment, Inc., Cal. St. Bd. of Equal., June 29, 1982.)

The Franchise Tax Board used the six-year moving average formula of Black Motor Co., 41 B.T.A. 300 (1940), affd. on other grounds, 125 F.2d 977 (6th Cir. 1942), to determine the appropriate amount for appellant's total bad debt reserve. Both the federal courts and this board have approved this method of determining a reasonable addition to a bad debt reserve. (See Thor Power Tool Co. v. Commissioner, *supra*, 439 U.S. at 548-549; Appeal of Brighton Sand and Gravel Company, Cal. St. Bd. of Equal., Aug. 19, 1981.)

Appellant has presented hypothetical examples purporting to show that application of the Black Motor Co. formula is erroneous, both in general and in appellant's case, because it does not consider factors other than appellant's previous loss experience, such as appellant's high risk loans and the growth in its business volume. Appellant is correct in pointing out that indiscriminate application of any formula is neither warranted nor reasonable. However, appellant has not shown that respondent's use of the Black Motor Co. formula was indiscriminate. It has not shown that the circumstances existing at the close of the taxable year required a different amount in its reserve than that determined by respondent.

Appellant had always made high-risk loans. That was the nature of its business. No showing has been made that the loans for 1977 involved any greater risk than those made previously. Although appellant's volume had increased, the increase appears to have been steady and regular, rather than sudden and extraordinary. In short, appellant has failed to show that "changed conditions in [1977] caused collection of its outstanding debts to be less likely than in the past." (Valmont Industries, Inc., 73 T.C. 1059, 1068 (1980).)

Respondent apparently made the required "adjustment between known circumstances and experience," (Calavo, Inc. v. Commissioner, 304 F.2d 650, 654 (9th Cir. 1962)) and determined that the known circumstances did not require any deviation from appellant's loss experience. Appellant has not shown that respondent abused its discretion in this determination and respondent's action, therefore, will be sustained.

