

JEWELERS

)  
)

Appearances:

For Appellant: William M. Weintraub  
Attorney at Law

For Respondent: Charlotte A. Meisel  
Counsel

O P I N I O N

This appeal is made pursuant to section 25666<sup>1/</sup> of the Revenue and Taxation Code—from the action of the Franchise Tax Board on the protest of Swiss American Jewelers against proposed assessments of additional franchise tax in the amounts of **\$7,654.34, \$8,183.07, \$5,107.15, and \$4,095.95** for the income years ended July 31, 1976, July 31, 1977, July 31, 1978, and July 31, 1979, respectively.

<sup>1/</sup> Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the income years in issue.

## Appeal of Swiss American Jewelers

The issue on appeal is whether respondent abused its statutory discretion in disallowing the claimed additions to appellant's bad debt reserve for the years in question.

Appellant is an accrual basis taxpayer whose principal business activity is the retail sale of jewelry. Appellant uses the installment method of reporting income and employs the reserve method to account for its bad debts.

Prior to respondent's action in this matter, appellant based its yearly additions to its bad debt reserve upon a percentage of the gross amount of its outstanding installment receivables at the end of each income year. Respondent determined that appellant's reserve account was overstated because the reserve amounts should have been based upon a percentage of the unrecovered capital, rather than the gross amount, of its outstanding receivables.

Accordingly, respondent adjusted appellant's allowable bad debt reserve for the years in question by using the formula set forth in Black Motor Co. v. Commissioner, 41 B.T.A. 300 (1940). After determining the reasonable amount which should have been in the reserve account for each of the years in question, respondent proceeded to compare each year's allowable reserve with the prior year's ending reserve balance. The controversy is that respondent began by comparing the unadjusted reserve balance as of the income year ended July 31, 1975, to the adjusted, allowable reserve level for 1976. By using the higher unadjusted beginning balance, respondent determined that appellant's reserve account as stated was not only adequate to cover 1976's allowable reserve level but all of 1977's allowable level and most of 1978's and 1979's allowable reserves as well. Therefore, almost all of the additions to appellant's reserve account claimed for the years in question were disallowed. The disallowed additions were added back into their respective year's gross income, appellant was assessed accordingly, and this appeal followed.

Respondent's authority to oversee appellant's use of the reserve system for bad debts comes from section 24348, which provides, 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."

## Appeal of Swiss American Jewelers

The issue on appeal is whether respondent abused its statutory discretion in disallowing the claimed additions to appellant's bad debt reserve for the years in question.

Appellant is an accrual basis taxpayer whose principal business activity is the retail sale of jewelry. Appellant uses the installment method of reporting income and employs the reserve method to account for its bad debts.

Prior to respondent's action in this matter, appellant based its yearly additions to its bad debt reserve upon a percentage of the gross amount of its outstanding installment receivables at the end of each income year. Respondent determined that appellant's reserve account was overstated because the reserve amounts should have been based upon a percentage of the unrecovered capital, rather than the gross amount, of its outstanding receivables.

Accordingly, respondent adjusted appellant's allowable bad debt reserve for the years in question by using the formula set forth in Black Motor Co. v. Commissioner, 41 **B.T.A.** 300 (1940). After determining the reasonable amount which should have been in the reserve account for each of the years in question, respondent proceeded to compare each year's allowable reserve with the prior year's ending reserve balance. The controversy is that respondent began by comparing the unadjusted reserve balance as of the income year ended July 31, 1975, to the adjusted, allowable reserve level for 1976. By using the higher unadjusted beginning balance, respondent determined that appellant's reserve account **as** stated was not only adequate to cover 1976's allowable reserve level but all of 1977's allowable level and most of **1978's and** 1979's allowable reserves as well. Therefore, almost all of the additions to appellant's reserve account claimed for the years in question were disallowed. The disallowed additions were added back into their respective year's gross income, appellant was assessed accordingly, and this appeal followed.

Respondent's authority to oversee appellant's use of the reserve system for bad debts comes from section 24348, which provides, 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."

BEFORE THE STATE BOARD OF EQUALIZATION  
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of )  
SWISS AMERICAN JEWELERS )

Appearances:

For Appellant: William M. Weintraub  
Attorney at Law

For Respondent: Charlotte A. Meisel  
Counsel

O P I N I O N

This appeal is made pursuant to section 25666<sup>1/</sup> of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Swiss American Jewelers against proposed assessments of additional franchise tax in the amounts of \$7,654.34, \$8,183.07, \$5,107.15, and \$4,095.95 for the income years ended July 31, 1976, July 31, 1977, July 31, 1978, and July 31, 1979, respectively.

<sup>1/</sup> Unless otherwise specified; all section references are to sections of the Revenue and Taxation Code as in effect for the income years in issue.

## Appeal of Swiss American Jewelers

By its election to use the reserve method for deducting bad debts, appellant has chosen to subject itself to the reasonable discretion of respondent. (Union National Bank & Trust Co. of Elgin v. Commissioner, 26 T.C. 537 (1956); Appeal of Livingston Bros., Inc., Cal. St. Bd. of Equal., Oct. 16, 1957.) Because of the **express statutory discretion given respondent**, the burden of proof on appellant in overcoming a determination by respondent is greater than the usual burden facing one who seeks to overcome the presumption of correctness which attaches to an ordinary notice of deficiency. As a result, the taxpayer must not only demonstrate that its additions to the reserve were reasonable, but also must establish that respondent's actions in disallowing these additions were arbitrary and amounted to an abuse of discretion. (Appeal of H-B Investment, Inc., Cal. St. Bd. of Equal., June 29, 1982.; Appeal of Brfghton Sand and Gravel Company, Cal. St. Bd. of Equal., Aug. 19, 1981.)

Respondent's use of and the results reached by the Black Motor Co. formula in recalculating appellant's allowable bad debt reserve is not disputed by appellant. Appellant objects, however, to the use of the July 31, 1975, unadjusted bad debt reserve balance in determining whether the additions to the reserve for the years at issue were reasonable.

Appellant argues that if it improperly used the face amount of the outstanding installment receivables to determine its reserve balance, to be consistent respondent must adjust all prior reserve levels to reflect only the unrecovered capital of the receivables. Such a re-determination would lower the reserve balance's dollar figure for 1975 and allow a greater share of the later additions in question to be deductible. Appellant asserts that the failure to readjust the balances prior to the years at issue would create the following inequity. First, respondent would recapture as income all of the excess additions to the reserve from past years which respondent is now barred from assessing by the statute of **limitations**. This recapture would apparently take place by the disallowance of most of the additions to the reserve during the years at issue. Appellant then appears to argue that by not allowing additions to the reserve, respondent is effectively disallowing a write-off for many of the bad debts appellant realized during the years at issue.

Section 24348, which was patterned after Internal Revenue Code section 166, allows a deduction for a

Appeal of Swiss American Jewelers

reasonable addition to a bad debt reserve. It is settled law in California that when state statutes are patterned after federal legislation on the same subject, the interpretation and effect given the federal provisions by the federal courts are relevant in determining the proper construction of the California statutes. (Andrews v. Franchise Tax Board, 275 Cal.App.2d.653 [**80 Cal.Rptr. 403**] (1969); Rihn v. Franchise Tax Board, 131 Cal.App.2d 356 [**280 P.2d 893**] (1955).)

In Ehlen v. United States, 323 F.2d 535 (Ct.Cl. 1963), the court was presented with a case factually **similar to** the one presently before this board. In response to an argument which echoes Swiss American Jewelers' contentions; the court in Ehlen ruled that:

We consider this argument untenable in that section 166(c) of the Internal Revenue Code of 1954 only allows a deduction for a reasonable addition to the reserve, and if the reserve is already unreasonably large, due to unnecessarily large additions in prior years, the statute [of limitations] does not require this past error to be continued in succeeding years by requiring further unnecessary additions to an already swollen reserve. The statute of limitations **bars inquiry into excessive additions closed by** the statute, but it does not prevent the Commissioner from disallowing additions to the reserve in years not closed by the statute when such additions are not needed.

(Ehlen v. United States, supra, 323 F.2d at 541.)

We find this reasoning persuasive, and we conclude, therefore, that respondent was correct in its use of appellant's unadjusted reserve balance for 1975 in denying the claimed additions for the years in question. Since appellant has failed to establish that respondent abused its statutory discretion-by reducing the claimed additions to appellant's bad debt reserve for the years in question, respondent's action in this matter will be sustained.

Appeal of Swiss American Jewelers

reasonable addition to a bad debt **reserve**, **It is settled** law in California that when state statutes **are** patterned after federal legislation on the same subject, the interpretation and effect given the federal provisions by the federal courts are relevant in determining the proper construction of the California statutes. (Andrews v. Franchise Tax Board, 275 Cal.App.2d.653 [80 Cal.Rptr. 403] (1969); Rihn v. Franchise Tax Board, 131 Cal.App.2d 356 [280 P.2d 893] (1955).)

In Ehlen v. United States, 323 F.2d 535 (Ct.Cl. 1963), the court was presented with a case factually **similar to** the one presently before this board. In response to an argument which echoes Swiss American Jewelers' contentions, the court in Ehlen ruled that:

We consider this argument untenable in that section 166(c) of the Internal Revenue Code of 1954 only allows a deduction for a reasonable addition to the reserve, and if the reserve is already unreasonably large, due to unnecessarily large additions in prior years, the statute [of limitations] does not require this past error to be continued in succeeding years by requiring further unnecessary additions to an already swollen reserve. The statute of limitations bars inquiry into excessive additions closed by the statute, but it does not prevent the Commissioner from disallowing additions to the reserve in years not closed by the statute when such additions are not needed.

(Ehlen v. United States, supra, 323 F.2d at 541.)

We find this reasoning **persuasive**, and we conclude, therefore, that respondent was correct in its use of appellant's unadjusted reserve balance for 1975 in denying the claimed additions for the years in question. Since appellant has failed to establish that respondent abused its statutory discretion-by reducing the claimed additions to appellant's bad debt reserve for the years in question, respondent's action in this matter will be sustained.

## Appeal of Swiss American Jewelers

By its election to use the reserve method for deducting bad debts, appellant has chosen to subject itself to the reasonable discretion of respondent. (Union National Bank & Trust Co. of Elgin v. Commissioner, 26 T.C. 537 (1956); Appeal of Livingston Bros., Inc., Cal. St. Bd. of Equal., Oct. 16, 1957.) Because of the **express statutory discretion given respondent**, the burden of proof on appellant in overcoming a determination by respondent is greater than the usual burden facing one who seeks to overcome the presumption of correctness which attaches to an ordinary notice of deficiency. As a result, the taxpayer must not only demonstrate that its additions to the reserve were reasonable, but also must establish that respondent's actions in disallowing these additions were arbitrary and amounted to an abuse of discretion. (Appeal of H-B Investment, Inc., Cal. St. Bd. of Equal., June 29, 1982.; Appeal of Brighton Sand and Gravel Company, Cal. St. Bd. of Equal., Aug. 19, 1981.)

Respondent's use of and the results reached by the Black Motor Co. formula in recalculating appellant's allowable bad debt reserve is not disputed by appellant. Appellant objects, however, to the use of the July 31, 1975, unadjusted bad debt reserve balance in determining whether the additions to the reserve for the years at issue were reasonable.

Appellant argues that if it improperly used the face amount of the outstanding installment receivables to determine its reserve balance, to be consistent respondent must adjust all prior reserve levels to reflect only the unrecovered capital of the receivables. Such a re-determination would lower the reserve balance's dollar figure for 1975 and allow a greater share of the later additions in question to be deductible. Appellant asserts that the failure to readjust the balances prior to the years at issue would create the following inequity. First, respondent would recapture as income all of the excess additions to the reserve from past years which respondent is now barred from assessing by the statute of limitations. This recapture would apparently take place by the disallowance of most of the additions to the reserve during the years at issue. Appellant then appears to argue that by not allowing additions to the reserve, respondent is effectively disallowing a write-off for many of the bad debts appellant realized during the years at issue.

Section 24348, which was patterned after Internal Revenue Code section 166, allows a deduction for a

