

Appeal of Charles McCandless
Tile Contractor, Inc.

The sole issue to be resolved in this appeal is whether respondent correctly adjusted the additions claimed by appellant to its bad debt reserve.

Appellant, a California corporation incorporated in 1960, uses the accrual method of accounting. On its franchise tax returns, it has selected the reserve method **of accounting** for its bad debts.

On its return for the income year ended June 30, 1980, appellant deducted \$13,500 as an addition to its bad debt reserve. At that time the existing balance was \$20,356. A recovery of \$2,680 and a charge of \$15,056 brought the reserve balance to \$21,480. In the income year ended June 30, 1981, appellant deducted \$16,566 as an addition to the reserve. Appellant recovered \$755 and charged \$3,885 to the reserve bringing the **end of** year balance to \$34,916. Appellant deducted \$16,774 as an addition to its reserve for the income year ended June 30, 1982. Recoveries of \$5,063 and charges of \$10,272 brought the balance to \$46,481.

Following an audit, respondent determined appellant's additions to its bad debt reserve were unreasonable and, pursuant to section 2'4348, recomputed the amount using the Black Motor Co. formula (Black Motor Co. v. Commissioner, 41 B.T.A. 300 (1940), affd. on other **issues**, 125 F.2d 977 (6th Cir. 1942))^{2/}. Appellant protested and this timely appeal followed.

Section 24348 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." This section is derived from, and is substantially similar to, section 166 of the Internal Revenue Code. Consequently, federal precedent is persuasive in interpreting section 24348. (Meanley v. McColgan, 49 Cal.App.2d 203 [121 P.2d 45] (1942).)

^{2/} The six-year moving average formula set out in Black Rotor Co. v. Commissioner, supra, and approved by the United States Supreme Court in Thor Power Tool Co. v. Commissioner, 439 U.S. 522 [58 L.Ed.2d 785] (1979), utilizes a taxpayer's own experience with losses in prior years and establishes a percentage level for the reserve to determine the need and amount of a current addition.

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Under the reserve method for handling bad debts, the reserve is reduced by charging against it specific bad debts which become worthless during the taxable year and is increased by crediting it with reasonable additions. In order to determine whether the amount deducted is reasonable, the test is whether the balance in the reserve at the end of the year is adequate to cover the anticipated worthlessness of the outstanding debts and not whether the proposed addition is sufficient to absorb the estimated losses. (Platt Trailer Co., Inc. v. Commissioner, 23 T.C. 1065 (1955); Black Motor Co. v. Commissioner, *supra*.) If the reserve is already adequate to cover the receivables which reasonably can be expected to become worthless, no deduction for an addition to the reserve is allowable for the taxable year. (Roanoke Vending Exchange, Inc. v. Commissioner, 40 T.C. 735 (1963).) Primarily, the reasonableness of any addition will depend on the total amount of debts outstanding at the end of the year, including current debts as well as those of prior years, and the total amount of the existing reserve. (Former Cal. Admin. Code, tit. 18, reg. 24348(g), (repealer filed September 3, 1982, Register 82, No. 37).)

As we have noted in previous opinions, respondent's determination with respect to additions to a reserve for bad debts carries great weight because of the express discretion granted to it in section 24348. As a result, the taxpayer must not only demonstrate that 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.)

Appellant argues that its reserve was reasonable if considered in light of the fact that some portion of the accounts receivable will ultimately be uncollectible even though the exact portion of the specific accounts cannot be discerned, and that the loss arising therefrom should be recognized in the period in which the revenue occurs. Appellant also argues that there is no requirement that the Black Motor Co. formula or any other formula be used in computing the reserve accounts and additions thereto. Finally, appellant points to the particular economic problems faced by the construction industry during the years at issue as a basis for maintaining a higher reserve.

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Appellant has not demonstrated that respondent's adjustments to the additions to its reserve account were arbitrary and **an abuse** of discretion. Appellant contends that there is no requirement that the Black Motor Co. formula or any **formula be** used in computing the reserve account and additions thereto. However, appellant fails to take into account the fact that a taxpayer may only establish, and add to, a reserve account at the discretion of respondent. In the absence of an abuse of this discretion, respondent's determination of what is a reasonable addition must be sustained.

In order to recompute appellant's additions to its bad debt reserve, respondent utilized the formula found in Black Motor Co. v. Commissioner, supra. Although the **use** of this formula is not required, it is within respondent's statutory discretion to use such a **widely** accepted and approved method to determine what would be a reasonable addition to appellant's reserve account. Respondent computed appellant's bad debt ratio to be **.01257142**. When applied to the trade notes and accounts receivable for income year ended June 30, 1982, a reserve balance of \$5,559 resulted, as follows:

<u>Income Year</u> <u>Ended</u>	<u>Amount of</u> <u>Appellant's</u> <u>Deduction</u> <u>for Reserve</u>	<u>Amount</u> <u>Allowed</u> <u>by</u> <u>Respondent</u>	<u>Adjusted</u> <u>Reserve</u> <u>B a l a n c e</u>
June 30, 1980	\$13,500	\$5,918	\$13,898
June 30, 1981	16,566	-0-	10,768.
June 30, 1982	16,774	-0-	5,559

For the reasons expressed below, we do not find respondent's use of the Black Motor Co. formula in the instant case to be an abuse of **discretion**.

Appellant contends that to require a balance of \$5,559 rather than \$46,481 is an abuse of discretion. However, as can be seen, the additions respondent allowed, although reducing the amount of the reserve account, still allows the account to remain adequate to ensure the coverage of the net charges for the appeal years. Appellant has not offered any facts to demonstrate the necessity of a larger reserve in these **years**, which would show that respondent was arbitrary, unreasonable, **or** abused its discretion in using the Black Motor Co. formula to reduce the additions to appellant's reserve account.

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Moreover, appellant has not offered any evidence to show that its additions to its bad debt reserve during the appeal years were reasonable. Appellant contends that taxpayers have considerable discretion in determining additions to reserve accounts. In reliance upon this, appellant states in its appeal that its reserve is based upon a percent of sales, varying between .5 percent and 1 percent of **gross sales** and cites general economic conditions and the condition of the construction industry specifically, as rationale for the variance in the percentage. Appellant further contends that a general aging of accounts should be, and was, considered in computing the additions to the bad debt reserve. Additionally, appellant contends that respondent had previously accepted a reserve balance of \$21,387 for 1977 as being reasonable. Appellant asserts that since receivables for 1982 were approximately twice those of 1977, a reserve balance of approximately twice as much as that of 1977 is reasonable.

Under the reserve method for handling bad debts, the reserve is reduced by charging against it specific bad debts which become worthless during the taxable year and is increased by reasonable additions. The reasonableness of the addition is determined by whether the balance in the reserve at the end of the year is adequate to cover the anticipated bad debt losses, (Platt Trailer co., Inc. v. Commissioner, supra; Black Motor Co. v. Commissioner, supra.) If the balance in the reserve is adequate to cover anticipated losses, an addition to the reserve will not be reasonable. (Valmont Industries, Inc. v. Commissioner, 73 T.C. 1059 (1980).)

In the instant case, appellant has not shown the inadequacy of the existing reserve balance. Appellant contends that an increase in net charges to the reserve for the three-year period ended June 30, 1982, (net charges of \$20,715) over net charges for the **three-year** period ending June 30, 1979, (net charges of \$5,756) indicates a requirement for an increased reserve account. However, appellant has not demonstrated that the account balance in any year or years has not been adequate to cover the net charges against the account. Accordingly, we must conclude that respondent's action in reducing the amount of the reserve was not an abuse of discretion.

Appellant makes one other argument on appeal. It argues that general economic conditions, especially in the construction industry, justified a larger addition to the bad debt reserve. We also find this argument

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unpersuasive. Appellant has failed to demonstrate that, even if economic conditions in the construction industry as a whole were poor, its ability to collect its receivables was affected.

For the reasons discussed above, we conclude that 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. Accordingly, respondent's action must be sustained.

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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,

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 Charles McCandless Tile Contractor, Inc., against proposed assessments of additional franchise tax in the amounts of \$698, \$1,590, and \$1,610 for the income years ended June 30, 1980, June 30, 1981, and June 30, 1982, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 4th day of February, 1986, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Collis, Mr. Bennett, Mr. Dronenburg and Mr. Harvey present.

<u>Richard Nevins</u>	, Chairman
<u>Conway H. Collis</u>	, Member
<u>William M. Bennett</u>	, Member
<u>Ernest J. Dronenburg, Jr.</u>	, Member
<u>Walter Harvey*</u>	, Member

*For Kenneth Cory, per Government Code section 7.9