



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
MULTIQUIP, INC.) No. 83A-251-PD
)

For Appellant: Pat Stein
Certified Public Accountant

For Respondent: Grace Lawson
Counsel

O P I N I O N

This appeal is made pursuant to section 25666^{1/} of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Multiquip, Inc., against proposed assessments of additional franchise tax in the amounts of \$2,870, \$3,167, and \$7,615 for the income years 1978, 1979, and 1980, respectively.

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

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The question presented by this appeal is whether appellant has demonstrated that respondent's disallowance of appellant's addition to its bad debt reserve for each of the appeal years was an abuse of respondent's discretion.

Appellant is a corporation which supplies a variety of machinery to small construction businesses nationwide. Appellant uses the accrual basis to report its California income and the reserve method for its bad debt accounting.

Upon the audit of appellant's 1977 return, respondent determined that appellant had created an excessive bad debt reserve, disallowed the bad debt deduction, and issued a notice of proposed assessment to appellant for that year. Appellant protested, arguing that it was a new business in a competitive market and that a large bad debt reserve was necessary because it had been required to extend risky credit in order to gain entry into that market. Appellant's customers were in the construction industry, which appellant argued was subject both to economic downturns and to bad weather which could impede contracting and construction work by appellant's customers and indirectly cause **appellant's** debts to go bad. Respondent accepted appellant's argument and withdrew its proposed assessment for 1977 and, in effect, accepted appellant's \$86,068 bad debt reserve for 1977.

In a subsequent audit, respondent disallowed **all of** appellant's 1978, 1979, and 1980 additions to its bad debt reserve and issued notices of proposed assessments based upon its adjustments. Appellant protested, advancing the same argument it had used against the proposed assessment for 1977. Respondent rejected appellant's argument for the years 1978 through 1980 and sustained its proposed assessments. This appeal followed.

Appellant argues here that its accounts receivable constituted 34 percent of its total assets while the industry average was 25 percent of total assets, and that this higher ratio of accounts receivable was accompanied by a higher risk, so that appellant's bad debt reserve accruals for the years at issue were justified. Further, appellant argues that comparing its additions to its bad debt reserve during the years at issue against a formula based upon appellant's bad debt experience during the preceding five-year period was highly unfair considering

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what had happened to the nation's economy during that five-year period.

In general, a reserve for bad debts is an estimate of future losses which can reasonably be expected to arise from obligations outstanding at the close of the income year. (Valmont Industries, Inc. v. Commissioner, 73 T.C. 1059 (1980); Appeal of Bay Area Financial Corporation, Cal. St. Bd. of Equal., Apr. 5, 1984.) Under the reserve method for handling bad debts, the reserve is reduced by charging against it specific bad debts which become worthless during the income year and is increased by crediting it with reasonable additions, which are deductible. What constitutes a reasonable addition depends upon 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 Aug. 3, 1982 (Register 82, No. 37).)

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." That section is derived from and is substantially the same as section 166 of the Internal Revenue Code. Consequently, federal precedent is persuasive of the proper interpretation of section 24348. (Meanley v. McColgan, 49 Cal.App.2d 203 [121 P.2d 451 (1942).) 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 it by statute. Under the circumstances, the taxpayer must not only demonstrate that its additions to the reserve were reasonable, but must demonstrate also that respondent's actions in disallowing those additions were arbitrary and amounted to an abuse of discretion. (Appeal of Brighton Sand and Gravel Company, Cal. St. Bd. of Equal., Aug. 19, 1981; Appeal of Vaughn F. and Betty F. Fisher, Cal. St. Bd. of Equal., Jan. 7, 1975.)

The most widely applied formula for determining proper additions to bad debt reserves is set forth in Black Motor Co. v. Commissioner, 41 B.T.A. 300 (1940), affd. on other issues, 125 F.2d 977 (6th Cir. 1942), which was approved by the U.S. Supreme Court in Thor Power Tool Co. v. Commissioner, 439 U.S. 522 [58 L.Ed.2d 785] (1979). That formula applies a taxpayer's own experience with losses in prior years and establishes a percentage level

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for the reserve in determining the need and amount of a current addition.

The following table, taken from information on appellant's returns, shows appellant's bad debt and reserve activity for the years 1974 through 1980:

<u>Income Year</u>	<u>Accounts Receivable</u>	<u>Addition to Reserve</u>	<u>Recov-eries Added to Reserve</u>	<u>Bad Debts Charged Against Reserve</u>	<u>Year End Bad Debt Reserve Balance</u>
1974	163,304	17,703		1,373	16,330
1975	190,087	21,837		19,159	19,008
1976	383,054	40,233		26,182	33,059
1977	668,019	63,975	8,221	19,187	86,068
1978	980,887	31,898	6,357	34,948	89,375
1979	1,378,925	35,184	13,344	16,934	120,969
1980	1,567,528	79,322	6,877	12,284	194,884

Respondent apparently made its estimate of allowable additions to appellant's bad debt reserve by first determining an overall bad debt **ratio for** the period 1975 **through 1980**. It divided the sum of **appellant's** bad debts charged against its bad debt reserve less **appellant's** recoveries on debts which had been written off during those years by the sum of appellant's trade notes and accounts receivable outstanding at the end of each of the years in that period. That ratio was **.0181667**. **Respondent then** multiplied that ratio by **\$1,567,528**, the amount of appellant's trade notes and accounts receivable outstanding at the end of 1980. The product, \$28,477, is an estimate of the amount of bad debts which would result if appellant's debts turned bad in the future at the same overall ratio that appellant had experienced from 1975 through 1980. Appellant's reported bad debt reserve at the end of 1980 was \$194,884. Thus, appellant's bad debt reserve at the end of 1980 exceeded respondent's estimated amount of appellant's future bad debts by \$166,407. That excess was greater than the \$146,404 sum of appellant's additions to its bad debt reserve during 1978, 1979, and 1980. Accordingly, respondent disallowed all those deductions from gross income for 1978, 1979, and 1980 which appellant's additions to its bad debt reserve in those years represented. Respondent's action complies with the rule that if the bad debt reserve is already adequate to cover the accounts receivable which can be expected to become worthless, no deductions for additions to the reserve would be allowable

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for the year in question. (Roanoke Vending Exchange Inc., v. Commissioner, 40 T.C. 735 (1963).)

Appellant alleges that its accounts receivable constituted a higher percentage of its assets than do the accounts receivable of other construction equipment rental companies nationwide. Even if that fact were true, it does not imply, much less require, a conclusion that appellant's future bad debts will constitute a higher proportion of its credit sales than appellant experienced in the past.

Appellant argues also that the possibilities of adverse business conditions and adverse weather conditions require additions to its bad debt reserve in excess of those allowed by respondent. But appellant has not demonstrated how those possibilities, which had certainly existed as possibilities in the past in addition to the perils faced by a commencing business, would specifically increase its expected ratio of bad debts. The adverse possibilities projected by appellant are that future business conditions may cause future outstanding debts to go bad at some higher ratio than appellant had so far experienced. But, however justified it may be, as a matter of sound business judgment, to establish a reserve against such contingencies, the bad debt reserve for tax purposes contemplated by section 24348 is not intended to be a reserve for those contingencies. (Roanoke Vending Exchange, Inc. v. Commissioner, supra; Massachusetts Business Development Corp. v. Commissioner, 52 T.C. 946 (1969).) Thus, we cannot find that appellant has demonstrated that respondent has abused its discretion in disallowing its additions to its bad debt reserve during the years at issue, and we must affirm respondent's action.

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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 Multiquip, Inc., against proposed assessments of additional franchise tax in the amounts of \$2,870, \$3,167, and \$7,615 for the income years 1978, 1979, and 1980, 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.

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

*For Kenneth Cory, per Government Code section 7.9