BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 82A-2084-MA
MID-WAY GMC, INC.)

For Appellant: Lyle E. Pierceall
Certified Public Accountant

For Respondent; George Bond
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 Mid-Way GMC, Inc., against proposed assessments of additional franchise tax in the amounts of $1,270, $3,448, and $3,562 for the income years ended July 31, 1979, July 31, 1980, and July 31, 1981, 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.

The sole issue to be resoived in this appeal is whether respondent abused its statutory discretion by denying the claimed additions to appellant's bad debt reserve for the years in question.

Appellant, a California corporation engaged in the business of selling automobiles and light duty trucks at retail, uses the accrual method of accounting. On its franchise tax returns, it has selected the reserve method of accounting for its bad debts. For the income years ended July 31, 1979, 1980, and 1981, appellant deducted $39,121, $36,877, and $37,108, respectively, as additions to its bad debt reserve. These amounts were arrived at through use of a 3 percent bad debt ratio.

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)), respondent determined that appellant's additions to its bad debt reserve were excessive for the income years 1979, 1980, and 1981 and issued proposed assessments for each of these years. This timely appeal follows.

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, 209 [121 P.2d 45] (1942).)

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 Machine Exchange, Inc. v. Commissioner, 40 T.C. [redacted] 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 by statute. 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.)

In determining whether appellant's additions to its bad debt reserve were reasonable, respondent applied the six-year moving average formula set out in Black Motor Co. 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). The Black Motor Co. formula 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. After applying this formula to appellant, respondent determined that the additions to the reserve were excessive.

Appellant contends that the use of the Black Motor Co. formula is inappropriate when a business had only been in existence a short time. Appellant further argues that the additional amounts of bad debt reserve taken in the years at issue were justified because: (i) the automobile market was economically depressed during the period in question; (ii) the economic conditions in the area were tenuous as a result of a reduction in work force and possible closure of a major local employer, and (iii) the reserve was not excessive compared to reserves held by other automobile dealers and financial institutions. We disagree.

Appellant has failed to carry its burden in that it has not established that respondent's use of the Black Motor Co. formula was either arbitrary or capricious. The use of this formula has been consistently upheld by this Board. (See generally Appeal of Victorville

Glass Co., Inc., Cal. St. Bd. of Equal., Oct. 26, 1983; Appeal of Vaughn F. and Betty F. Fisher, Cal. St. Bd. of Equal., Jan. 7, 1975.) Appellant's contention that the use of formula is inappropriate when, as here, the business has only been in existence for six years is without merit. We have upheld the use of the formula for test periods of even shorter duration. (Appeal of Victorville Glass Co., Inc., supra; Appeal of Vaughn F. and Betty F. Fisher, supra.)

Appellant makes other arguments which attempt to justify its use of the 3 percent debt ratio. All center around its contention that the economic climate, particularly the depressed automobile industry and the fact that a major local employer was in danger of closing, required the higher ratio. We find these arguments unpersuasive. Appellant has failed to provide any factual evidence to sustain these contentions. While we recognize that these factors might affect sales, appellant has failed to demonstrate how a depressed automobile industry and a sagging local economy affected its ability to collect its debts or even whether these factors affected appellant's business at all.

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.

Appeal of Mid-Way GMC, Inc.

ORDER

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 Mid-Way GMC, Inc., against proposed assessments of additional franchise tax in the amounts of $1,270, $3,448, and $3,562 for the income years ended July 31, 1979, July 31, 1980, and July 31, 1981, respectively, be and the same is hereby sustained.

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

Richard Nevins, Chairman

Conway H. Collis, Member

Ernest J. Dronenburg, Jr., Member

Walter Harvey*, Member

_____, Member

*For Kenneth Cory, per Government Code section 7.9