



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of }
SAM ELLIS STORE, INC.) No. 86A-414-AJ

Appearances:

- For Appellant: Lawrence I. Tannenbaum
Attorney at Law

- 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 **front the** action of the Franchise Tax Board on the protest of Sam Ellis Store, **Inc.,** against proposed assessments of additional **franchise** tax in the amounts of \$769, \$2,900, and \$3,367 for the income years ended June 30, 1979, June 30, 1980, and June 30, 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.

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The issue presented for decision is whether respondent abused its discretion in recomputing a reasonable addition to appellant's, bad debt reserve.

Appellant is a California corporation engaged in the retail department store business. It is an accrual-basis taxpayer which has selected the reserve method of accounting for its bad debts. Appellant's retail operations are located in Calexico, a town close to the Mexican border, and a large portion of its sales are to Mexican customers. Collecting delinquent accounts from these customers is a continuing problem, since appellant cannot sue them for payment.

During the years at issue, and for some time prior to those years, the Mexican economy was unstable. The **government** devalued the peso in 1976 and 1982. Because of this situation, appellant increased its claimed additions to its bad debt reserve during the years at issue. Respondent determined that appellant's additions were excessive and recomputed the additions using the formula derived from the decision in Black Motor Co. v. Commissioner, 41 B.T.A. 300 (1940), affd. on other grounds, 125 F.2d 977 (6th Cir. 1942). Respondent issued proposed assessments disallowing part of appellant's deductions and affirmed those **assessments after** considering appellant's protest. Appellant then filed this appeal.

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." 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 and Trust Co. of Elgin v. Commissioner, 26 T.C. 537, 543 (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 respondent's determination of a reasonable addition to a bad debt reserve is greater than the usual burden facing one who seeks to overcome the presumption of correctness which attaches to an ordinary notice of deficiency. Appellant must do more than demonstrate that its additions to the reserve were reasonable; it must establish that respondent's determination of the additions was so unreasonable and arbitrary as to constitute

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an abuse of discretion. (Roanoke Vending Exchange, Inc. v. Commissioner, 40 T.C. 735 (1963); Appeal of Vaughn F. and Betty F. Fisher, Cal. St. Bd. of Equal., Jan. 7, 1975.)

The Black Motor bad debt formula utilized by respondent was approved by the United States Supreme Court in Thor Power Tool Co. v. Commissioner, 439 U.S. 522 [58 L.Ed.2d 785] (1979), and by this board in the Appeal of Brighton Sand and Gravel Company, decided August 19, 1981. Since it is settled that the Black Motor formula is valid, the only question is **whether respondent** abused its discretion by using the formula in this case. If a taxpayer's recent bad debt experience is unrepresentative or if the taxpayer can point to conditions that will cause future debt collections to be **less likely** than in the past, the **taxpayer is** entitled to an addition larger than the Black Motor formula would provide. (Thor Power Tool Co. v. Commissioner, supra.)

Appellant contends **that the** instability of the Mexican economy during the appeal years caused the Black Motor formula to be inapplicable and that the devaluation **of the peso** made a larger addition to its bad debt reserve necessary. Respondent apparently agrees that a larger addition **would** be necessary for 1982, the year in which the peso was officially devalued, but contends that use of the Black Motor formula is 'appropriate for the years prior to 1982. Appellant argues that since respondent agrees that a larger addition is needed in the year of the official devaluation of the peso, appellant need only prove that the actual devaluation occurred during the years at issue. We need not determine whether this is correct, since appellant has not established that an actual devaluation occurred prior to 1982. Appellant contends that any official devaluation of the peso is preceded by an unofficial or 'black market' devaluation. It further contends that the black market exchange rates, 'interest **rates** paid Mexican banks, and **the** public's perception during the appeal years establish that an actual devaluation of the peso occurred several years prior to the 1982 official devaluation. Unfortunately, appellant has not supported these general assertions with evidence. Therefore, it has not proven that an actual devaluation occurred during the appeal years. Without proof of an **actual** devaluation, appellant's only justification for an addition larger than warranted by past experience is Mexico's poor economic condition. Such generalizations regarding business or economic

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conditions do not meet the taxpayer's heavy burden of proving that respondent's use of the Black Motor formula was inappropriate and amounted to an abuse of discretion. (Atlantic Discount Company, Inc. v. United States, 473 F.2d 412 (5th Cir. 1973); Fairmont Homes, Inc. v. Commissioner, ¶ 83,209 T.C.M. (P-El) (1983).) We must conclude, therefore, that appellant has not carried its burden of proving that respondent abused its discretion in recomputing a reasonable addition to appellant's bad debt reserve.

For the above reasons, respondent's **action** must be sustained.

