



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
LIVINGSTON BROS., INC.)

Appearances:

For Appellant: Alfred A. Ferguson,
Certified Public Accountant

For Respondent: Burl D. Lack, Chief Counsel;
F. Edward Caine, Associate
Tax Counsel

O P I N I O N

This appeal is made pursuant to Section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of Livingston Bros., Inc., to proposed assessments of additional franchise tax in the amounts of \$68.27 and \$55.11 for the income years ended January 31, 1947, and January 31, 1948, respectively,

Since some time prior to 1944 Appellant has claimed deductions for bad debts on the reserve method for both Federal and State purposes. For the years ended in 1944 and 1945 the Bureau of Internal Revenue disallowed \$3,628.82 and \$5,676.82, respectively, of the amounts deducted by Appellant on its Federal income tax returns as additions to its reserve for bad debts.

On September 20, 1948, the Franchise Tax Commissioner (now succeeded by the Franchise Tax Board) proposed an additional assessment for the income year ended in 1945, based on the inclusion in income, among other items, of the sum of \$3,628.82, the amount of the Federal adjustment for the year ended in 1944. Within the time allowed therefor, Appellant filed its protest to the proposed assessment of tax arising from the inclusion in income of this item, on the ground that the "disallowance in question was for the year ended January 31, 1944," and that an assessment for that year was barred by the statute of limitations.

Upon consideration of the protest the Commissioner informed Appellant that "If the adjustment is not made in the year ended January 31, 1945, all additions to the bad debt reserve will be disallowed in subsequent years until

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the bad debt reserve is down to a reasonable amount. If you would prefer to withdraw the protest and leave the proposed assessment stand, it will save the trouble of taking different deductions and having different reserves for State and Federal purposes and over a period of years there will be no difference in the net income." Appellant refused to withdraw its protest and the Commissioner thereafter eliminated this item from the proposed assessment.

Appellant did not claim a bad debt deduction on either its Federal or State return for the income year ended in 1946. On its returns for the income years ended in 1947 and 1948 it deducted only for accounts which became uncollectible in those years, in the aggregate amounts of \$5,496.88 and \$6,761.38, respectively. For the year ended in 1947 the Commissioner allowed the claimed deduction to the extent of recoveries, but disallowed it as to the excess of \$2,007.81. For the year ended in 1948 the Commissioner disallowed \$1,621.01 of the amount claimed. The total of the amounts thus disallowed was \$3,628.82, an amount identical to that disallowed by Federal taxing authorities for the year ended in 1944. The sole issue for our determination is the propriety of the adjustments by the Franchise Tax Commissioner for the income years ended in 1947 and 1948.

Appellant alleges that bad debt deductions claimed on its returns for the income years ended in 1947 and 1948 must be allowed in full because they represented actual charge-offs, rather than additions to a reserve for bad debts. The gravamen of its appeal, however, appears to be that the Franchise Tax Commissioner did in fact disallow the sum of \$3,628.82 claimed during the year ended in 1944 as an addition to Appellant's reserve for bad debts, but failed to make a timely assessment of the tax arising from the disallowance. The error of this position is that the Franchise Tax Commissioner did not make, nor even purport to make, any adjustment to Appellant's income or tax as reported on its return for the year ended in 1944. Certainly his unconsummated proposal to make an upward adjustment to Appellant's taxable income for the year ended in 1945 did not diminish Appellant's accumulated reserve for bad debts. In the absence of such a reduction, it requires no citation of authority to refute the contention that a mere proposal to assess an additional tax for the year ended in 1945 constituted a disallowance of the deduction claimed, and for which Appellant received a tax benefit, in the year ended in 1944.

Section 8(e) of the Bank and Corporation Franchise Tax Act (now Section 24348 of the Revenue and Taxation Code), as it read during the years in question allowed a deduction for:

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"Debts which became worthless within the income year, or, in the discretion of the Commissioner, a reasonable addition to a reserve for bad debts...."

By its election to use the reserve method for deducting bad debts Appellant under the statute subjected itself to the discretion of the Franchise Tax Commissioner. Union National Bank and Trust Co. of Elgin, 26 T.C. 537. Having adopted the reserve method it could not have changed to a specific charge-off method without the express consent of the Commissioner. Rogan v. Commercial Discount Co., 149 Fed. 2d 585, certiorari denied,, 326 U.S. 764. Moreover, such a change would have required Appellant to report as income for the year in which the change was made the entire unexpended balance in its reserve for bad debts. Peabody Coal Co. v. Commissioner, 18 B.T.A. 1081, affirmed, 55 Fed. 2d 7, certiorari denied, 287 U.S. 605. Since Appellant did not obtain the consent of the Franchise Tax Commissioner to change to a specific charge-off method, did not change its books from the reserve method and did not report as income the unexpended balance of its accumulated reserve for bad debts, we conclude that it used the reserve method of treating bad debts for the years in question, The reasonableness of the additions to the reserve in those years was, accordingly, subject to review and determination by the Franchise Tax Commissioner.

That the claimed additions to the reserve for the years in question were limited each year to the aggregate amount of the accounts which became uncollectible in that year does not in itself establish their reasonableness, The determining factor is not whether the additions to the reserve were sufficient to absorb the bad debts that arose during the years in question, but whether the reserve itself was sufficient for that purpose, Krim-Ko Corporation, 16 T.C. 31; Platt Trailer Co., 23 T.C. 1065.

Appellant points out that its accounts receivable increased from approximately \$390,000 to \$530,000 during the year ended in 1947, and from approximately \$530,000 to \$675,000 during the year ended in 1948, It has not, however, presented any evidence to show that without the additions in question its accumulated reserve for bad debts was inadequate to meet the needs of its expanded business, Nor has it explained why it needed during those years a larger reserve for State tax purposes than for Federal purposes. At the end of each year its unexpended reserve ran between \$40,000 and \$50,000, whereas its net bad debt losses over recoveries amounted to only \$2,007.81 in the year ended in 1947 and \$1,797.37 in the year ended in 1948. Upon these facts Appellant has failed to sustain the "heavy burden" of showing

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an abuse of discretion by the Franchise Tax Commissioner.
S. W. Coe & Co. v. Dallman, 216 Fed. 2d 566; Maverick-Clarke
Litho Co. v. Commissioner, 180 Fed. 2d 587.

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 protests of Livingston Bros., Inc., to proposed assessments of additional franchise tax in the amounts of \$68.27 and \$55.11 for the income years ended January 31, 1947, and January 31, 1948, respectively, be and the same hereby sustained.

Done at Los Angeles, California, this 16th day of October, 1957, by the State Board of Equalization,

Robert E. McDavid, Chairman
J. H. Quinn, Member
George R. Reilly, Member
Paul R. Leake, Member
_____, Member

ATTEST: Dixwell L. Pierce, Secretary