



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
PRINGLE TRACTOR CO.)

For Appellant: Wilbur H. Stevens
Certified Public Accountant

Wm. H. Shervey
Vice--President-Treasurer

For Respondent: Crawford H. Thomas
Chief Counsel

Lawrence C. Counts
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 protest of Pringle Tractor Co, against a proposed assessment of additional franchise tax in the amount of \$761.88 for the income year 1962. After this appeal was filed, respondent conceded that the assessment should be reduced by \$113.46 because of an error in computation.

Appellant is a California corporation engaged in selling hardware and farm equipment. It has elected to use the reserve method of accounting for bad debts and claiming its bad debt deduction.

At the discretion of respondent Franchise Tax Board, a taxpayer may deduct a reasonable addition to a bad debt reserve in lieu of deducting specific bad debts, (Rev. & Tax, Code, §24348.) The question to be decided here is whether respondent abused its discretion in refusing to allow a deduction of the full amount of appellant's reserve addition for the year 1962 as a "reasonable addition."

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Appellant has consistently followed the practice of making additions to its bad debt reserve account based upon its rating of specific accounts and notes considered to be of doubtful collectibility. At the beginning of the year 1962 the balance in its bad debt reserve account totaled \$93,642. For the year 1962 it made additions to the reserve totaling \$34,359 and charged off \$10,051, resulting in a book reserve balance of \$117,950 as of December 31, 1962. Of the total face value of the specific notes and accounts which formed the basis for additions to the reserve, \$103,429 was written off as worthless in subsequent years. During the year 1963, appellant sustained actual bad debt losses of \$99,285 and recovered \$1,086 from accounts and notes previously written off as worthless.

Utilizing a formula computation, respondent determined that appellant's average bad debt loss for the years 1959 to 1963, inclusive, amounted to approximately 3 percent of its average outstanding notes and accounts receivable for those years. Applying this average loss ratio to notes and accounts outstanding for the year 1962, respondent recomputed the allowable reserve additions and disallowed \$13,850 of appellant's bad debt deduction for that year. The following table shows the basis for the calculation:

<u>Year</u>	<u>Out standing Notes & Accounts</u>	<u>Net Losses</u>	<u>Ratio</u>
1959	\$ 568,899	\$ 783	.14%
1960	1,108,045	(1,022)	(.09%)
1961	663,279	13,624	2.05%
1962	752,403	8,723	1.16%
1963	872,616	97,950	11.22%

Since a reasonable addition is by the term of section 24348 of the Revenue and Taxation Code, allowable as a bad debt deduction at the discretion of respondent, the determination can be set aside only if appellant sustains its "heavy burden" of showing that respondent's action was an abuse of its discretion. (Walter H. Goodrich & Co., 40 B.T.A. 960; Platt Trailer Co., 23 T.C. 1065.)

It is appellant's position that computation of an allowable reserve addition by use of respondent's formula was arbitrary and, therefore, an abuse of discretion because the formula did not take into account pronounced cyclical variations to which appellant's business is subject.

A computation of an allowable addition by the application of a formula is not in itself an abuse of discretion. Determination of the question does not turn upon the method used to compute the addition. Results obtained under variations of the method used by respondent, a method which takes into

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consideration the taxpayer's credit and loss history, have been judicially approved. (Black Motor Co., 41 B.T.A. 300, aff'd, 125 F.2d 977; S. W. Coe & Co., v. Dallman, 216 F.2d 566.)

A reserve addition obtained through averaging a taxpayer's loss experience over a period of years, however, is not reasonable per se. For the years 1959 to 1962, inclusive, appellant's actual net losses from bad debts did not exceed \$13,624 in any one year. The ratio of its net losses to outstanding notes and accounts for those years varied greatly, reaching a maximum of 2.05 percent. In 1963, the year after the one in question, appellant's net bad debt losses were \$98,199 and its loss ratio was 11.47 percent. Had respondent excluded the year 1963 from its computations, the amount of the reserve that would have been obtained at the end of 1962 would have been totally insufficient to cover the losses in the following year. Subsequent loss experience may be weighed in determining the reasonableness of an addition made by a taxpayer in a prior year (The Shield Co., 2 T.C. 763), but it should be borne in mind that at the time appellant made its addition, it could only estimate its future losses. Although no one of the above facts is conclusive, they weigh against the reasonableness of respondent's action.

It is apparent that appellant had obtained information in 1962 that collection of certain of the large notes and accounts outstanding was doubtful and that it based its reserve requirements on this information. It was proper for appellant to consider these known circumstances in determining the amount of the addition since the estimate as to the amount of reserve required for any given year is to be measured in light of the conditions which exist at the time the estimate is made, (G. P. Ford & Co., 28 B.T.A. 156; Calavo, Inc. v. Commissioner, 304 F.2d 650.) The record confirms (1) that appellant actually sustained extremely abnormal bad debt losses during the year 1963, and (2) that its bad debt reserve addition for 1962, representing a forecast of the amount required to provide an adequate reserve for those losses was, under the circumstances, reasonable.

Upon the particular facts of this appeal, we find that it was an abuse of discretion for respondent to reduce the reserve addition made by appellant, (Platt Trailer Co., 23 T. C. 1065; Anna Neuman, T.C. Memo., Dkt. No. 22907, Oct. 3, 1950; Apollo Steel Co., T.C. Memo., Dkt. No. 3436, April 13, 1945.)

O R D E R

Pursuant to the view expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

