



Appeal of H-B Investment, Inc.

Appellant, owned 50 percent each by brothers Jens and Helge Harms, began extracting gravel and fabricating road asphalt in 1958. It is an accrual basis taxpayer that has selected the reserve method for its bad debt accounting.

On March 16, 1973, appellant sold its partnership interest in the Madison Sand and Gravel Company to Syar, Inc., in exchange for that purchaser's \$195,518 promissory note; sold its partnership interest in Leisure Town to Syar, Inc., in exchange for that purchaser's \$130,137 promissory note; and sold its shares of stock in Yolano Engineers, Inc., to Syar and Harms Industries, Inc., in exchange for that purchaser's \$55,964 promissory note. The sales agreement for each transaction provided that the principal amount of each note was to be repaid in four annual installments, commencing in April 1980. In the interim, interest at five percent per year was to be paid monthly. Appellant could elect to declare the unpaid principal and accrued interest immediately due if any principal or interest payments were not timely made.

Two weeks after executing the sales contracts, appellant executed an agreement to subordinate all or a portion of its claims against the purchasers to the claims of Wells Fargo Bank. Apparently, the subordination agreement permitted the interest payments on the promissory notes to continue. Syar, Inc., subsequently liquidated into Syar and Harms Industries, Inc., and the latter changed its name to Syar Industries, Inc., 77.6 percent of the stock of which is owned by C. M. Syar.

Jens and Helge Harms and C. M. Syar are long-time friends and business associates. They had participated in numerous joint ventures, some involving the entities in which appellant sold its interests on March 16, 1973. Appellant's representative stated that the March 16, 1973, sales were part of a process by which the Harms family disassociated their business and investment holdings from those of Mr. Syar.

From 1973 through 1977, Jens and Helge made gifts and sales of stock to their children. Appellant's stock became owned 50 percent by Eric Harms, 33 percent by Michael Harms, and 17 percent by Peter Harms,

Appellant received the last interest payment made on the notes on November 30, 1974. Later in June 1976, appellant's attorneys made a written demand for payment of both the principal and the accrued interest

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on the notes. Appellant was informed that payment could not be made then or later.

Appellant's returns for 1975, 1976 and 1977 included deductions for additions to its bad debt reserve of \$162,543, \$115,621 and \$125,060, respectively, a total of \$403,224, which it attributed to principal and accrued interest on the notes. No portion of the debts, however, were charged off as worthless during 1975, 1976 or 1977; the full amounts of the notes continued to be carried as receivables on appellant's books.

Respondent audited appellant's returns and determined that appellant was not entitled to deduct those additions to its bad debt reserves. Respondent issued proposed assessments reflecting that determination. Appellant protested. After a hearing, respondent reviewed the matter and affirmed its action. This appeal followed.

Section 24348 of the Revenue and Taxation Code 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 45] (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 additions to the reserve were reasonable, but also must establish 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.)

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The most widely applied formula for determining proper additions to bad debt reserves is set forth in Black Motor Co., 41 B.T.A. 300 (1940), affd. on other issues, 125 F.2d 977 (6th Cir. 1942), 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 for the reserve in determining the need and amount of a current addition. At respondent's request, appellant computed reasonable bad debt reserve balances for 1975, 1976 and 1977 using the Black Motor Co. formula. Formula balances for those years were \$5,961, \$5,776 and \$4,870. The balances appellant used for its returns for those years were \$236,243, \$367,127 and \$573,540. The balances respondent used in computing the proposed assessments for those years were \$73,700, \$251,506 and \$448,540. Thus, the balances respondent has allowed are in excess of the balances indicated by the Black Motor Co. formula.

Bad debt reserve accounts are intended to handle only normal losses that arise in the ordinary course of a taxpayer's day-to-day operations. Losses which are rare or unpredictable in nature and amount should be handled apart from the taxpayer's bad debt reserve. (Rev. Rul. 74-409, 1974-2 Cum. Bull. 61.) The notes in question arose from appellant's sales of its interests in other business entities and not in the course of its own day-to-day gravel and asphalt business. Thus, we see no reason why respondent's disallowance of appellant's additions to its bad debt reserves on this basis alone would be an abuse of respondent's statutorily granted discretion.

Before notes can be deducted as bad debts, the taxpayer must demonstrate that they actually became worthless in the year deducted. In respect to the alleged uncollectibility of the notes, appellant points out that the debtors stopped making payments in late 1974; that after the default, in June 1976, it made a written demand for immediate payment of the principal and interest due on the notes and was told by the purchasers that any future payments were impossible; and that the notes were subordinated to the interests of a superior creditor, the Wells Fargo Bank. On the other hand, the record indicates that appellant received no security for the promissory notes; appellant agreed to a distant maturity date for the notes; appellant agreed to subordinate its interest to that of a later creditor two weeks after taking the notes; appellant made no serious

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collection effort after the interest payments stopped other than making the written demand for the sum of the accelerated principal and interest due; and appellant's owners and managers had a long-standing friendship and business relationship with C. M. Syar. In short, the record raises doubts as to whether appellant expected full payment on the notes or was willing to enforce payment. Clearly, a debtor's temporary insolvency or refusal to pay does not establish that a debt is uncollectable. (See Phillip C. Hughes, ¶ 51,063 P-H Memo. T.C. (1951); Richards & Hirschfeld, Inc., 24 B.T.A. 1289 (1931); Production Steele, Inc., ¶ 79,361 P-H Memo. T.C. (1979).) Here, Syar Industries, Inc.'s net working capital may have decreased by \$1,514,942 from a deficit of \$715,856 to \$2,233,798 for the year ended March 31, 1,974, but appellant has not demonstrated that the purchasers were in such financial difficulty that it would have been appropriate to conclude that the notes were uncollectable. We note that Wells Fargo Bank was willing to extend credit to the purchasers. in 1973, and that, apparently, the purchaser's business has continued uninterrupted through the years in question to the present date.

Finally, appellant maintains that deductions should be allowed for each year at issue for that portion of the notes which became uncollectable in each year. In this regard, Revenue and Taxation Code section 24348(a) provides, in pertinent part:

When satisfied that a debt is recoverable in part only the Franchise Tax Board may allow such a debt, in an amount not in excess of the part charged off within the income year, as a deduction; . . .

Appellant, however, has not advanced any evidence here that would support a conclusion that some specific portion of the notes became worthless in each year at issue. In any event, appellant did not charge off any portion of the notes during those years.

We can only conclude that appellant has neither demonstrated that respondent has abused its discretion in disallowing the claimed additions to appellant's bad debt reserve nor demonstrated that part or all of the debts in question became worthless during the years here on appeal.

