



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
HOLLYWOOD COMMUNITY HOSPITAL,)
Taxpayer, and HOLLYWOOD COMMUNITY)
HOSPITAL, Assumer and/or Transferee)

For Appellant: Sidney J. Matzner
Certified Public Accountant

For Respondent: Jean Ogrod
Counsel

O P I N I O N

This appeal is made pursuant to section 25666 of the Revenue and Taxation Code from the action of the **Franchise Tax** Board on the protest of Hollywood Community Hospital, Taxpayer, and Hollywood Community Hospital, Assumer and/or Transferee, against a proposed assessment of additional franchise tax in the amount of \$3,866 for the income year ended March 31, 1975.

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The issue for decision is whether appellant has **established that** respondent's action requiring it to include in income for the year at issue its bad debt reserve account is in error.

Hollywood Community Hospital, taxpayer (hereinafter "appellant"), a **for-profit** California corporation, operated a hospital facility in Los Angeles. It used the accrual method of accounting and the reserve method of reporting bad debts. In March of 1975, **DeLongpre Hospital Company** (hereinafter "**DeLongpre**"), a California tax-exempt organization, purchased 100 percent of the stock of appellant for \$2,500 per share or a total purchase price of \$500,000. On March 14, 1975, pursuant to a document entitled "Agreement of Merger,"-. the assets and liabilities of appellant were transferred to DeLongpre, and appellant was thereupon dissolved. In 1976, DeLongpre changed its corporate name to Hollywood Community Hospital.

As part of the measure of appellant's tax for its last year in existence, respondent included in appellant's income the balance of its bad debt **reserve** account (\$77,085) as of the date of the merger and cessation of business. Appellant's protest was denied and this appeal followed.

Revenue and Taxation Code section 24348, subdivision (a), provides that in lieu of specific deductions for bad debts "[t]here shall be allowed ..., in the discretion of the Franchise Tax Board, a reasonable addition to a reserve for bad debts." Regulation 24348(c) (Cal. Admin. Code, tit. 18, reg. 24348(c)) deals with the taxability of bad debt reserves of taxpayers who cease to be subject to the California franchise tax. Regulation 24348(c) provides, in relevant part:

Since additions to a bad debt reserve reduced the amount of tax which otherwise would have been due, any amount received from the sale or other disposition of receivable's for more than their net tax basis in the year that a taxpayer ceases to be subject to the tax imposed by this part or **ceases to** be subject to a tax measured by net income is required to be included in the measure of tax for the last year that a taxpayer was subject to tax measured by or imposed upon net income to the extent that the amounts derived from such sale resulted in

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a tax benefit. As used in this regulation the term "net tax basis" means the face value of **accounts** receivable when sold, less amounts which have been set aside as a reserve for bad debts.

Applying this regulation, respondent concluded that upon the merger of appellant into DeLongpre, the balance in the bad debt reserve account was includable in appellant's income for the year ended March 31, 1975. Respondent contends that since DeLongpre was a tax exempt organization and, accordingly, paid no franchise tax, the need for the bad debt reserve for tax purposes ceased upon the merger and that the bad debt reserve balance must be included in taxable income for appellant's last year. The substance of appellant's argument in opposition is that the shareholders valued the shares sold by valuing the receivables at a price net of the bad debt reserve account so that the amounts derived from the disposition did not result in a tax benefit which would be returnable to income.

A bad debt reserve essentially constitutes an estimate of the loss which can reasonably be expected to result from the worthlessness of debts outstanding at the close of the taxable year. It is well settled "that any balance in a reserve for bad debts existing when the reserve becomes no longer necessary must be included in taxable income, since the amount of such balance represents amounts which have been previously deducted." (J. E. Hawes Corp., 44 T.C. 705, 707 (1965); see also, Arcadia Savings and Loan Association v. Commissioner, 300 F.2d 247 (9th Cir. 1962); West Seattle National Bank of Seattle v. Commissioner, 288 F.2d 47 (9th Cir. 1961).) As we have stated, the theory behind this principle of income restoration is that by taking deductions in earlier years, the taxpayer has benefited through a reduction of its taxable income, and when subsequent events demonstrate that there was in fact no loss, the reserve must be included in taxable income. (Appeal of Pasadena First National Bank et al., Cal. St. Bd. of Equal., March 4, 1965.) Accordingly, under the bad debt reserve method, subsequent realizations (as by way of sale or other disposition) on obligations previously charged against the reserve represent income earned in the past which has escaped taxation. (Ira Handleman, 36 T.C. 560, 568 (1961).)

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By electing to use the reserve method, appellant subjected itself to the discretion of respondent. (Rev. & Tax. Code, § 24348, subd. (a).) The scope of this discretion includes requiring that the balance of the reserve be restored to income in appropriate circumstances. (Appeal of Pasadena First National Bank, et al., supra.) In cases interpreting the comparable federal statute, it has been held the Internal Revenue Commissioner's discretion must be reasonable, However, "the Commissioner's determination is prima facie correct and the taxpayer has the burden of proving error in the Commissioner's determination." (Union National Bank & Trust Co. of Elgin, 26 T.C. 537, 543 (1956).) More specifically, the burden of proof is upon the taxpayer to show that respondent has abused its discretion. (Roth Packing Co., § 62,078 P-H Memo. T.C. (1962).)

Based upon the record before us, we cannot say that appellant has established that respondent has abused its statutory discretion in this matter. As indicated above, appellant's only argument on appeal is that the accounts receivable were valued at a price net of the bad debt reserve so that at their disposition no tax benefit was received and, therefore, no taxable income was realized. Not only has appellant not established those facts which would support this conclusion, but also this theory has been severely criticized. (Bird Management, Inc., 48 T.C. 586, 597 (1967); see also, Harry G. LaForge, 53 T.C. 41 (1969).)

Accordingly, we hold that respondent's action of restoring to income the balance of the bad debt account was proper.

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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 protest of Hollywood Community Hospital, Taxpayer, and Hollywood Community Hospital, Assumer and/or Transferee, against a proposed assessment of additional franchise tax in the amount of **\$3,866** for the income year ended March 31, 1975, be and the same is hereby sustained.

Done at Sacramento, California, this 15th day of September' 1983, by the State Board of Equalization, with Board Members Mr. Bennett, Mr. Collis, Mr. Dronenburg, Mr. Nevins and Mr. Harvey present.

<u>William M. Bennett</u>	, Chairman
<u>Conway H. Collis</u>	, Member
<u>Ernest J. Dronenburg, Jr.</u>	, Member
<u>Richard Nevins</u>	, Member
<u>Walter Harvey*</u>	, Member

*For Kenneth Cory, per Government Code section 7.9