

Appeal of Western Leisure Properties, Inc.

The primary question presented by this appeal is whether appellant was entitled to deduct additions to bad debt reserves. If it was so entitled, we must consider whether respondent abused its discretion in disallowing appellant's claimed additions to its dealer bad debt reserve.

Appellant is an accrual basis taxpayer engaged in retail boat sales. When appellant sells a boat under an installment sales contract, it discounts the contract to a bank. Appellant must guarantee the performance of the contract, and the bank withholds 5 percent of the discounted amount as collateral for this performance. This amount is released when the contract is fulfilled.

On appellant's returns for its income years ended in 1978 and 1979, it deducted additions to both a dealer's bad debt reserve and a bad debt reserve. Those for the dealer's reserve equaled the amounts withheld by the bank on the discounted contracts--\$62,273 and \$61,013 for 1978 and 1979, respectively. The additions for the bad debt reserve were just over \$3,500 for each year. Actual bad debt charge-offs against the bad debt reserve for those years were \$245 and \$8,006. No charge-offs were made against the dealer's reserve.

Respondent determined that the additions to the dealer's reserve were excessive and disallowed them entirely. After this appeal was filed, respondent examined appellant's returns from prior years and discovered that on its first franchise tax return, appellant had elected the specific charge-off method of accounting for bad debts and had never obtained permission to change to the reserve method of accounting for bad debts. Therefore, respondent contends that appellant was not entitled to deductions for additions to any bad debt reserve.

Revenue and Taxation Code section 24348, subdivision (a), allows a deduction for "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." Similar provision is made under federal law in Internal Revenue Code section 166(a) and (c).

A taxpayer selects the method he wishes to use on the return for the first taxable year in which he is entitled to a bad debt deduction, and, if that method is approved by the Franchise Tax Board, the taxpayer must continue to use that method unless the Franchise Tax

Appeal of Western Leisure Properties, Inc.

Board grants permission to change it. (Former Cal. Admin. Code, tit. 18, reg. 24348(d), **subd. (2)**, repealer filed Sept. 3, 1982 (Register 82, No. 37); Treas. Reg. § 1.166-1(b).)

On its first tax return, appellant used the specific charge-off method of deducting bad debts. It has never requested, or been granted, permission to change to the reserve method. Therefore, it is only entitled to deduct the debts which it can show have become worthless during the income year. It is also not entitled to use a dealer's **reserve**, since Revenue and Taxation Code section 24348, subdivision **(b) (1)**, provides for a dealer's reserve only "in lieu of any deduction under subdivision (a)" of that section.

Appellant has not shown that it is entitled to use the reserve method nor has it shown that it is entitled to a bad debt deduction in excess of that allowed by the Franchise Tax Board. Having so concluded, we need not address the question of whether respondent abused its discretion. Respondent's action, therefore, must be sustained.

