



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
A-1 ENTERPRISES, INC.)

For Appellant: Robert A. Eickhoff
President

For Respondent: Paul J. Petrozzi
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 A-1 Enterprises, Inc., against a proposed assessment of additional franchise tax and penalty in the total amount of \$22,253 for the income year ended October 31, 1979.

Appeal of A-1 Enterprises, Inc.

The sole issue for decision in this appeal is whether appellant has shown that the respondent's determination of a reasonable addition to its bad debt reserve was an abuse of discretion.

Appellant, a California corporation principally engaged in the wholesale plant nursery business, is an accrual basis taxpayer which has elected the reserve method of accounting for its bad debts. On its franchise tax return for the income year ended October 31, 1979, appellant claimed a deduction for an addition to its bad debt reserve in the sum of \$209,637. Respondent determined \$11,824 was a reasonable addition and disallowed \$197,813 of the claimed deduction. In addition, respondent imposed the penalty under section 25933 of the Revenue and Taxation Code for appellant's failure to furnish requested information. After the filing of this appeal, however, respondent determined to abate the penalty. Consequently, the proposed assessment of franchise tax resulting from the disallowance of appellant's claimed addition to its bad debt reserve is all that remains at issue.

Section 24348 of the Revenue and Taxation Code allows a deduction for additions to a reserve for bad debts in lieu of a deduction of a specific debt that becomes worthless within the income year. The section provides that, if a taxpayer elects to employ the reserve method of accounting for its bad debts, any addition claimed will be subject to the discretion of respondent. This section is derived from and is substantially the same as Internal Revenue Code section 165, which vests discretion in the Commissioner of Internal Revenue to determine the reasonableness of an addition to a reserve for bad debts. Federal precedent, therefore, is persuasive of the proper interpretation of section 24348. (Meanley v. McColgan, 49 Cal.App.2d 203 [121 P.2d 453 (1942)].)

Because of this discretion granted to respondent by statute, this board has consistently declared that respondent's determinations in regard to an addition to a reserve for bad debts carry great weight. (Appeal of Vaughn F. and Betty F. Fisher, Cal. St. Bd. of Equal., San. 7, 1975.) Accordingly, we have held that a taxpayer who seeks to overturn a ruling by respondent bears a heavy burden of proof. The taxpayer is required not only to demonstrate that its claimed addition to the reserve was reasonable, but it must also establish that respondent's action in disallowing the claimed addition for

Appeal of A-1 Enterprises, Inc.

the year in question was arbitrary and amounted to an abuse of discretion. (Roanoke Vendina Exchange, Inc., 40 T.C. 735 (1963); Appeal of H-B Investment, Inc., Cal. St. Bd. of Equal., **June 29, 1982**; Appeal of Brighton Sand and Gravel Company, Cal. St. Bd. of Equal., Aug. 19, 1981; Appeal of Vaughn F. and Betty F. Fisher, supra.)

In general, a reserve for bad debts is an estimate of future losses which can reasonably be expected to arise from obligations outstanding at the close of the income year. (Valmont Industries, Inc., 73 T.C. 1059 (1980); Appeal of Bay Area Financial Corporation, Cal. St. Bd. of Equal., April 5, 1984.) Under the reserve method for handling bad debts, the reserve is reduced by charging **against it** specific bad debts which become worthless during the income **year** and is increased by crediting it with reasonable additions which are deductible. (Roanoke Vending Exchange, Inc., supra.) What constitutes a reasonable **addition** depends upon the total amount of debts outstanding at the **end** of the year, including current debts as well as those of prior years, and the total amount of the existing reserve. (Former Cal. Admin. Code, tit. 18, req. 24348(g), repealer filed September 3, 1982 (Register 82, No. 37),)

A basic requirement for an addition to a bad debt reserve is that the addition must reflect conditions existing at the end of the income year in question. (Roanoke Vending Exchange, Inc., supra; Appeal of Foothill Bank, Cal. St. Bd. of Equal., **June 27, 1984**; Treas. Reg. § 1.166-4(b)(1).) The actual loss experience of a taxpayer in years subsequent to the income year in question may be used only as additional evidence to confirm the reasonableness or unreasonableness of the taxpayer's method of computing the claimed addition to the reserve. (Roanoke Vending Exchange, Inc., supra; Massachusetts Business Development Corp., 52 T.C. 946 (1969).) **Thus**, a taxpayer may not rely only upon its subsequent loss experience to support the reasonableness of its claimed addition. (See Westchester Development co., 63 T.C. 198 (1974).)

In the instant **matter**, respondent employed the six-year moving average derived from the decision in Black Motor Co., 41 B.T.A. 300 (1940), affd. on other grounds, 125 F.2d 977 (6th Cir. 1942), to determine whether appellant's claimed addition to its bad debt reserve was reasonable. The use of this formula to calculate additions to a reserve was upheld by the United

Appeal of A-1 Enterprises, Inc.

States Supreme Court in the decision in Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 546-550 [58 L.Ed.2d 785] (1979). This formula essentially utilizes the recent loss experience of the taxpayer and establishes a percentage level for the bad debt reserve in determining the need and amount of an addition for a current income year. Respondent applied the formula to appellant and found that the claimed addition was not justified by its bad debt history in the six years prior to the income year in question.

Appellant argues that respondent's use of the formula set forth in the case of Black Motor Co., supra, to calculate an addition to its reserve was not reasonable in light of revelations from a subsequent investigation of its debt history. In 1983 after filing a petition in bankruptcy, appellant maintains that it discovered that its bad debt reserve had been inadequate in prior years to cover losses caused by its handling of accounts receivable. Apart from this unsupported statement, appellant has not introduced any evidence to show that its own method for calculating the claimed addition to the reserve was reasonable in light of conditions existing at the end of the income year at issue. Without this foundational showing for the claimed addition, we cannot rely solely upon appellant's subsequent loss experience, even had it been supported by documentation, to find that the claimed addition was reasonable. (See Westchester Development Co., supra; Roanoke Vending Exchange, Inc., supra.) Finally, the record is equally void of any evidence that would tend to show that respondent acted arbitrarily or abused its discretion when it determined the adjustment to appellant's bad debt reserve.

Based on the foregoing, we find that appellant has failed to carry its burden of proof. Accordingly, except for the penalty, respondent's action in this matter shall be sustained.

Appeal of A-1 Enterprises, Inc.

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 A-1 Enterprises, Inc., against a proposed assessment of additional franchise tax and penalty in the total amount of \$22,253 for the income year ended October 31, 1979, be and the same is hereby modified in accordance with respondent's concession regarding the penalty. In all other respects, the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, **this 10th** day of October , 1984, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Dronenburg, Mr. Collis, Mr. Bennett and Mr. Harvey present.

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

*For Kenneth Cory, per Government Code section 7.9