



Appeals of Venture Out, Inc.

The sole issue for our decision is whether appellant has shown that respondent's disallowances of claimed additions **to a** reserve for guaranteed debt obligations constituted an abuse of discretion.

Appellant is a California corporation that sells recreational motor vehicles. **During the** normal course of its business operations in the appeal years, appellant guaranteed loans that were made by various institutional lenders to buyers to finance the purchase of the vehicles. If a customer defaulted on his loan **payments**, appellant agreed to repossess the vehicle and pay the lender the unpaid balance of the buyer's loan. **As an** accrual-basis taxpayer, appellant **elected the** reserve method of accounting for its **bad debts**.

On its returns for the 1979 and 1980 income years, appellant claimed repossession-loss deductions of **\$55,132 and \$297,989, respectively, as additions to a reserve for guaranteed debt obligations. After charge-offs for alleged** losses were **taken** into account, the reserve, as a **result of these claimed additions, was increased to \$410,004 in 1979 and \$573,656 in 1980.**

**Upon audit, the Franchise Tax Board discovered** that appellant calculated the loss charge-offs by subtracting the unpaid **balance of** defaulted loans from the low bluebook **value** of the repossessed vehicles. The actual losses suffered by appellant were \$95,685 in 1979 and \$158,266 in 1980. Respondent recalculated appellant's **reserve** for 1980 by taking a moving three-year average of total **actual losses over** total outstanding loan guarantees or contingent liabilities and applying this loss ratio against appellant's **contigent** liabilities for 1980. As a result, respondent determined that the allowable amount of appellant's guaranteed debt reserve for 1980 should be \$112,107 and disallowed as excessive appellant's **claimed** additions for both 1979 and 1980. Appellant paid the resultant deficiency assessments but filed claims for refund that **were** later denied.

**On its returns for the 1981 and 1982** income years, appellant claimed repossession-loss deductions of \$206,884 and \$213,002, respectively, as further additions to the reserve. After noting that appellant's actual losses were \$110,127 in 1981 and \$131,764 in 1982, respondent recalculated its allowable reserves for these **two years**, again using **a** moving average loss ratio of total actual losses over total contingent liabilities. Based on its calculation of an appropriate amount for

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appellant's reserve, respondent issued deficiency assessments which disallowed \$170,559 of the claimed addition for 1981 and \$62,795 of the claimed addition for 1982. Appellant has filed appeals from the denial of its protest against the deficiency assessments for 1981 and 1982, as well as from the denial of its refund claims for 1979 and 1980. The appeals have been consolidated for purposes of this decision.

Section 24348 allows a deduction for a reasonable addition to a **reserve for bad debts** in lieu of a deduction of a specific debt that becomes worthless within the income year. Under subdivision (b), a taxpayer, who is a dealer in property, may deduct a reasonable addition to its bad debt reserve for those bad debts which may arise out of its liability as a guarantor, endorser, or indemnitor of debt obligations from its sales of real or tangible personal property in the ordinary course of its trade or business. The reasonableness of any addition claimed is subject to the discretion of the Franchise Tax Board. Since section 24348, subdivision (b), is **substantially** similar to Internal Revenue Code section 166(f), <sup>2/</sup> which grants discretion to the commissioner to determine the reasonableness of federal taxpayer's addition to its reserve for guaranteed debt obligations, the interpretation and effect given the federal provision by the federal administrative bodies are highly relevant in determining the proper construction of the California statute. (Meanley v. McColgan, 49 Cal.App.2d 203, 209 [121 P.2d 45] (1942); see Appeal of John Z. and Diane W. Mraz, Cal. St. Rd. of Equal., July 26, 1976, and the cases cited therein.) The rules governing the reasonableness of an addition to a bad debt reserve are similarly applicable to a reserve for guaranteed debt under section 166(f). (Treas. Reg. § 1.166-10, subd. (b); see also Citrus Motors Ontario, Inc. v. United States, 249 F.Supp. 425, 427-28 (S.D. Cal. 1965).)

In general, a reserve for bad debts represents an estimate of future losses which can reasonably be expected to be sustained from obligations outstanding at the close of the income year. (Valmont Industries, Inc. v. Commissioner, 73 T.C. 1059 (1980); Eandelman v.

<sup>2/</sup> Section 166(f) was recently repealed by the Tax Reform Act of 1986, P.L. 99-514, October 22, 1986, 100 Stat. 2361.)

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Commissioner, 36 T.C. 560 (1961).) The purpose of a reserve is not to acquire protection against the contingency of excessive losses in subsequent years.

(Massachusetts Business Development Corp. v. Commissioner, 52 T.C. 946 (1969)) 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. v. Commissioner, 40 T.C. 735 (1963)) What constitutes a reasonable addition is a factual matter depending upon conditions of business prosperity, 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. - (Treas. Reg. **§ 1.166-4(b)(1)**; Mills & Lupton Supply Company, Inc. v. Commissioner, ¶ 77,294 T.C.M. (P-H) (1977).)

The ultimate question in determining the reasonableness of an addition is whether the total balance in the **reserve at year's end** is adequate to cover the expected **future losses** from existing bad debts, not whether the proposed addition is sufficient for that purpose. (Black Motor Co. v. Commissioner, 41 B.T.A. 300 (1940), affd. on other grounds, 125 F.2d 977 (6th Cir. 1942); Massachusetts Business Development Corp. v. Commissioner, supra.) If the existing reserve is **adequate to** cover reasonably anticipated losses, any further additions to the reserve will be considered unreasonable and not deductible. (Valmont Industries, Inc. v. Commissioner, supra; James A. Messer Co. v. Commissioner, 57 T.C. 848 (1972).)

Respondent's determination with regard to an addition to a **reserve carries** great weight due to the discretion granted to it by statute. (Appeal of Vaughn F. and Betty F. Fisher, Cal. St. Bd. of Equal., Jan. 7, 1975.) Accordingly, should a taxpayer challenge the disallowance by the Franchise Tax Board of a claimed addition to a reserve, the taxpayer bears a particularly heavy burden of proof. The taxpayer is required not only to demonstrate that its claimed addition is reasonable, but it must also establish that respondent's action in disallowing the claimed addition was arbitrary and amounted to an abuse of discretion. (Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 547-48 [58 L.Ed.2d 785] (1979); Appeal of Brighton Sand and Gravel Company, Cal. St. Bd. of Equal., Aug. 19, 1981.)

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In its determinations to disallow appellant's claimed additions, the Franchise Tax Board used a working **average** formula to calculate the appropriate amounts for appellant's reserve. Respondent contends that its formula is similar to the six-year moving average formula derived from the decision in Black Motor Co. v. Commissioner, supra. The use of the Black Motor formula, which utilizes the loss experience of the **taxpayer in the** previous six years and establishes a percentage level for the reserve in determining the need and amount of an addition for a current income year, was upheld by the United States Supreme Court in Thor Power Tool Co. v. Commissioner, supra. In rebuttal, appellant argues simply that the Franchise Tax Board used the wrong figures to calculate the appropriate reserve amounts. Appellant further argues that respondent did not provide it with any worksheets or evidence supporting the disallowances. Appellant, however, has not presented any evidence to show that its claimed additions are reasonable or that respondent acted arbitrarily or abused its discretion in disallowing its claimed additions. Based on the record in this appeal, we have no choice but to find that appellant has failed to carry its burden of proof. Accordingly, respondent's **actions** in these matters must be sustained.

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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 26077 of the Revenue **and** Taxation Code, that the action of the Franchise Tax Board in denying the claims of Venture Cut, Inc., for refund of franchise tax in the amounts of \$4,962 and \$28,309 for the income years ended October 31, 1979, and October 31, 1980, respectively, and section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Venture Out, Inc., against proposed assessments of additional franchise tax in the amounts of \$16,374 and \$4,938 for the income year ended October 31, 1981, and October 31, 1982, respectively, be and the same is hereby sustained.

**Done** at Sacramento, California, this 17th day Of June , 1987, by the State Board of Equalization, with Board Members Mr. Collis, **Mr.**Dronenburg, Mr. Bennett, **Mr.** Carpenter and Ms. Baker present.

<u>Conway H. Collis</u>	, Chairman
<u>Ernest J. Dronenburg, Jr.</u>	, Member
<u>William M. Bennett</u>	, Member
<u>Paul Carpenter</u>	, Member
<u>Anne Baker*</u>	, Member

\*For Gray Davis, per Government Code section 7.9