



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of
BROADWAY VACUUM CLEANERS STORE

Appearances:

For Appellant: H. F. Schimmerling, Public
Accountant

For Respondent: John S. Warren, Associate Tax
Counsel

O P I N I O N

This appeal is made pursuant to Section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of Broadway Vacuum Cleaners Store to proposed assessments of additional franchise tax in the amounts of **\$151.51**, \$178.24 and \$30.18 for the taxable years ended September 30, 1950, 1952 and **1953**, respectively, based on income for the years ended September **30, 1950** and 1952.

Appellant is a California corporation engaged in the business of selling vacuum cleaners. The business was originally operated as a partnership, composed of Walter Zeisl and Gustav W. Peters. Zeisl died on June **17, 1949**. Peters continued the business as a sole proprietorship and agreed to pay the decedent's estate \$15,000 for Zeisl's interest, which had a value in the partnership books of \$20,723.48.

Appellant was incorporated on October 1, 1949, Peters transferring to it the business and assets in exchange for all of its stock. The assets were recorded by Appellant at the book value used by the partnership, adjusted for transactions occurring during Peters' sole proprietorship.

Appellant took deductions for additions to its bad debt reserve in the amounts of \$3,573.20, \$1,548.24 and **\$754.68** on its franchise tax returns for the income years ended September 30, 1950, 1951 and 1952, respectively. The following entries appeared on the returns:

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	<u>Beginning</u>	<u>Ending</u>
Income year ended September 30, 1950:		
Accounts receivable	\$25,935.49	\$17,951.19
Reserve for bad debts	702.41	2,362.20
Income year ended September 30, 1951:		
Accounts receivable	17,951.19	10,154.18
Reserve for bad debts	2,362.20	2,554.39
Income year ended September 30, 1952:		
Accounts receivable	10,154.18	13,944.41
Reserve for bad debts	2,554.39	2,438.35

(The return for the income year ended September 30, 1951, showed a net loss and that year, accordingly, is not in question in--'this--appeal.)

The Franchise Tax Board disallowed the deductions for the ~~additions to the~~ bad debt reserve on the grounds that the reserve was ample--without the additions. In arriving at this conclusion,--the Franchise Tax Board first determined that the basis of the purchased assets in the hands of Peters should be reduced by \$5,723.48, the difference between the book value of the assets and the amount which Peters paid for them. It found that this reduction in price was attributable to the ~~accounts receivable because they were of doubtful worth while the book value of the inventory,~~ which was carried at cost, and the book value of the remaining assets approximated their fair market value. The Franchise Tax Board then determined that the basis of the assets of the business as the same in the hands of the Appellant as it was in the hands of Peters, since the transfer of them to Appellant constituted a tax-free exchange. In order to reflect ~~to~~ decreased basis, ~~the accounts receivable, if treated the bad debt reserve as increased by \$5,723.48.~~ In this posture, the additions claimed by Appellant would have increased the reserve to approximately 40 percent of the accounts on hand at the end of the income years in question. The Franchise Tax Board therefore concluded that the additions were unreasonable.

Appellant contends that the main reason for the difference between the partnership book value of all the assets and the amount that Peters paid for them was that the inventory was overvalued on the books. Appellant also states that the bad debt reserve which it adopted was used up entirely in later years.

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At the outset, a fundamental principle should be mentioned which must be observed in the determination of this matter. When the Franchise Tax Board disallows an addition to a reserve for bad debts, its action carries with it more than the usual presumption of correctness, since the applicable statute expressly provides that the allowance is, in its discretion. (See former Sections 24121f of the Revenue and Taxation Code and 8(e) of the Bank and Corporation Franchise Tax Act.) Its action may not; accordingly, be set aside unless an abuse of discretion on its part is established. * (Maverick-Clarke Litho Co. v. Commissioner, 180 Fed. 2d 587; Art Metal Construction Co. v. u. s., 17 Fed. Supp. 854.)

Appellant has not presented any reason for upsetting the conclusions of the Franchise Tax Board that Appellant's basis for all of the assets acquired from Peters should be the same as Peters' basis and that Peters' basis was his cost. (See former Sections 17741 of the Revenue and Taxation Code and 21 (a)(6) of the Bank and Corporation Franchise Tax Act.) Nor has Appellant offered any evidence to support an allocation of cost significantly different from the allocation made by the Franchise Tax Board.

The only evidence offered by Appellant was testimony by Peters. Peters indicated that the inventory was overvalued on the partnership books but he especially emphasized the dubious worth of the accounts receivable. Inasmuch as the inventory was carried on the books at cost, we consider it unlikely that it was overvalued to any material extent or that it accounted for a significant part of the price reduction. On the other hand, we are not persuaded that the accounts receivable were so worthless as to call for additions to the large reserve that resulted from the adjustment made by the Franchise Tax Board.

The fact that the bad debt reserve was used up in later years does not in itself justify the additions made during the years in question as Appellant has not taken into account the adjustment made by the Franchise Tax Board. Moreover, additions to the reserve in later years may have been insufficient in the light of conditions then prevailing.

Under the circumstances, we are unable to conclude that the action of the Franchise Tax Board in disallowing deductions for additions to the bad debt reserve for the years in question constituted an abuse of discretion.

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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 protests of Broadway Vacuum Cleaners Store to proposed assessments of additional franchise tax in the amounts of \$151.51, \$178.24 and \$30.18 for the taxable years ended September 30, 1950, 1952 and 1953, respectively, based on income for the years ended September 30, 1950, and 1952, be and the same is hereby sustained.

Done at San Diego, California, this 24th day of June, 1960, by the State Board of Equalization.

John W. Lynch, Chairman

_____, Member

George R. Reilly, Member

Paul R. Leake, Member

Richard Nevins, Member

ATTEST: Dixwell L. Pierce, Secretary