



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
MATHEWS CHEMICAL & SUPPLY c o .)

For Appellant : **Ross O. Provence**
Attorney at Law

For Respondent: **Crawford H. Thomas**
Chief Counsel

James W. Hamilton
Supervi sing Counsel

Robert S. Shelburne
C o u n s e l

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 protest of Mathews Chemical & Supply Co. against a proposed assessment of additional franchise tax in the amount of **\$1,100** for the income year ended June 30, 1964.

Appellant is a California corporation engaged in the business of selling agricultural products and welding equipment in the South Bay area of **San Diego County**. The corporation uses the reserve method of accounting for bad debts and for claiming bad debt deductions. At the beginning of the year in question appellant had a balance of **\$21,244** in its reserve account. Appellant computed a \$23,306 addition to the account for that year by taking 5.124 percent of sales. This percentage was derived from the corporation's experience with bad debt write-offs during the two preceding years and from a review of aging, doubtful debts owed to appellant. Bad debts of **\$6,089** were charged against the bad debt reserve account for the year in question. This left an end of the year balance of **\$38,461**. During the following year bad debts of **\$17,114** were charged against the reserve account.

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The Franchise Tax Board audited appellant's return for the year at issue and compared the bad debts which appellant had charged against the reserve account during each of the six years ended on June 30, 1959, through 1964, with appellant's notes and accounts receivable outstanding at the end of each of these years. When these six comparisons were averaged they indicated that bad debts approximated 8.4 percent of notes and accounts receivable. Since appellant had stated, that during the past five or six years (approximately 1962 through 1967) farm economic conditions changed and consequently the corporation had been **required to** extend more liberal credit and had suffered a greater number of bad debts, **respondent repeated** the above **comparisons** for the six years **ended** on June*30, 1962 through 1967. The resulting **figure** Was approximately 11.2 percent. Application of this percentage **to** the \$132,217 of notes and accounts receivable outstanding at the end of the year in question yielded anticipated bad debts of \$14,808. The Franchise Tax Board disallowed \$20,000 of appellant's \$23,306 claimed addition to the reserve **account.** Respondent states that the remainder was allowed in order to give some effect to **appellant's** allegation⁸ that debt **collec-**
tion conditions had worsened. Whether the above **disallowance** **was** proper is the sole Issue of this case.

Section 24348 of the Revenue and Taxation Code **states in part:**

There shall be allowed as a deduction 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.

Under this statute the taxpayer has the heavy burden of proving that the Franchise Tax Board abused its discretion. (Platt Trailer Co., 23 T.C. 1065; Appeal of The United Savings and Loan Association, Cal. St. Bd. of Equal., Nov. 19, 1968.) In order to satisfy this burden it is not enough for the taxpayer to show that its computation of the addition to the reserve account was reasonable, but the taxpayer must also show that the Franchise Tax Board's computation was arbitrary, and unreasonable. (Phlen v. United States, 323 F.2d 535; Roanoke Vending Exchange, Inc. 40 T.C. 735; S. W. Coe & Co. v. Dallman, 216 F.2d 566.) The computation of a reasonable addition must take into consideration the balance existing in the reserve account at the end of the income year, for **it** is this balance plus the addition which are allowed to be large enough to absorb **reasonably anticipated bad debts**, not merely the addition itself. (Roanoke Vending Exchange, Inc., supra; Krim-Ko Corp., 16 T.C. 31.)

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In the instant situation the Franchise Tax Board used an accepted formula to compute anticipated bad debts of \$14,808. (Enlen v. United States, supra, 323 F.2d 535; S. W. Coe & Co. v. Dallman, supra, 216 F.2d 566; Black Motor Co., 41 B.T.A. 300, aff'd, 125 F.2d 977.) Appellant's \$15,155 end of the year reserve balance, alone, was larger than this anticipated amount. However respondent allowed a \$3,306 addition in an effort to give some effect to appellant's allegations that debt collection conditions had worsened. The reasonableness of this addition, which enlarged the reserve to \$18,461, tends to be demonstrated by the \$17,114 of bad debts which appellant charged against the reserve account in the following year. (Roanoke Vending Exchange, Inc. supra, 40 T.C. 735.3

Appellant has not attempted to show that respondent's computation was arbitrary or unreasonable. Appellant does contend that respondent should have limited the application of its formula to the three-year period of 1962 through 1964. This would have yielded a figure of approximately 15 percent. However the rationale for such a limitation is not given, and we think that the six-year period chosen by respondent, 1962 through 1967, was a reasonable attempt to consider the unfavorable trend in debt collections alleged by appellant. We conclude that appellant has not carried its burden of proving that respondent abused its discretion. Therefore the Franchise Tax Board's position must be upheld.

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,

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IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25'667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Mathews Chemical & Supply Co. against a proposed assessment of additional franchise tax in the amount of \$1,100 for the Income year ended June 30, 1964, be and the same is hereby sustained.

Done at Sacramento, California, this 26th day of March, 1969, by the State Board of Equalization.

Geo. L. Perry, Chairman.
Paul R. Drake, Member
Richard Kern, Member
_____, Member
_____, Member

ATTEST:

J. H. Hanna, Secretary