BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
BRIGHTON SAND AND GRAVEL)
COMPANY)

For Appellant: Renato R. Parenti
Certified Public Accountant

For Respondent: Carl G. Knopke
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 Brighton Sand and Gravel Company against proposed assessments of additional franchise tax in the amounts of $1,679, $1,209, and $6,505 for the income years ended May 31, 1973, 1974, and [redacted]

[redacted]

[redacted]

Appeal of Brighton Sand and Gravel Company

The issue for determination is whether respondent abused its statutory discretion by reducing the claimed additions to appellant's bad debt reserve for the years in question.

Appellant, a California corporation, is an accrual basis taxpayer that has elected the reserve method for accounting for its bad debts. For the appeal years appellant deducted $72,276, $46,002, and $94,653, respectively, as additions to its bad debt reserve. These deductions amounted to 28.6 percent, 12.9 percent, and 26.6 percent of appellant's receivables outstanding at the end of each year. However, according to respondent's computations, the six-year moving average of actual charges against the bad debt reserve was 4.04 percent, 2.78 percent and 1.52 percent, respectively, of appellant's receivables outstanding for each year. Appellant explained that, primarily, the large additions to the reserve were due to the doubtful collectibility of three accounts,, The accounts are described in the following table:

	Principle	Accrued Interest	Total Amount Due
Rancho Cordova Corp.	$64,862	$41,870	$106,732
Cordova Village, Inc,	41,165	29,739	70,904
Cordova Lodge, Inc.	1,000	73	1,073
Total	$107,027	$71,682	$178,709

Specifically, appellant alleges that $72,000 of the Rancho Cordova Corp. debt became worthless in the year ended May 31, 1973; $14,000 of the same debt became worthless in the year ended May 31, 1974; and the remainder of the debts amounting to $92,709 became worthless in the year ended May 31, 1975. However, none of the allegedly worthless debts were ever charged off during the appeal years.

As the result of an audit, respondent determined that reasonable additions to appellant's reserve for bad debts were $21,971, $27,078 and 0, respectively, for the income years ended May 31, 1973, 1974 and 1975. Appellant's protest was denied and this appeal followed.

Section 24348 of the Revenue and Taxation Code provides, 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.

Similar provisions are contained in the federal law. (Int. Rev. Code of 1954, § 166.)

Under the reserve method for handling bad debts, the reserve is reduced by charging against it specific bad debts which become worthless during. the taxable year and is increased by crediting it with reasonable additions. The ultimate question concerning the deductibility of a reasonable addition to the bad debt reserve is whether the balance in the reserve at the end of the year is adequate to cover the anticipated worthlessness of outstanding debts and not whether the proposed addition is sufficient to absorb the estimated losses. (Platt Trailer Co., Inc., 23 T.C. 1065 (1955); Black Motor Co., 41 B.T.A. 300 (1940), aff'd on other issues, 125 F.2d 977 (6th Cir. 1942).) If the reserve is already adequate to cover the receivables which reasonably can be expected to become worthless, no deduction for an addition to the reserve is allowable for the taxable year. (Roanoke Vending Exchange, Inc., 40 T.C. 735 (1963) .) However, where an account becomes worthless during the taxable year, the full amount may be included in the taxpayer's addition to its reserve and deducted if the aggregate addition to the bad debt reserve is reasonable. (Compare Colavo, Inc. v. Commissioner, 304 F.2d 650 (9th Cir. 1962) and Stockton Morris Plan Co., ¶ 43,326 P-H Memo. T.C. (1943) with New York Water Service Corp., 12 T.C. 780 (1949) and H. Wolff Book Mfg. Co., Inc., ¶ 50,269 P-H Memo. T.C. (1950).) Primarily, the reasonableness of any addition **will depend on 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. (Cal. Admin. Code, tit. 18, reg. 24348, subd. (g).)**

Respondent's determination with respect to additions to the reserve for bad debts carries great weight **because of the express statutory discretion granted. Accordingly, the burden of proof on a taxpayer is greater than the usual burden applicable to overturning an ordinary notice of deficiency.** (Roanoke Vending

Exchange, Inc., supra; Appeal of Vaughn F. and Betty F. Fisher, Cal. St. Bd. of Equal., Jan. 7, 997'5.) The taxpayer must not only demonstrate that additions to the reserve were reasonable, but also establish that respondent's actions in disallowing those additions for the year in question were arbitrary, and amounted to an abuse of-discretion. (Roanoke Vending Exchange, Inc., supra; Appeal of Vaughn F. and Betty F. Fisher, supra.)

The foundation for appellant's claimed additions to its bad debt reserve is based on extrapolations from an audit of its financial condition as of May 31, 1971. Part of the audit included an in-depth analysis of the ability of each of the three Cordova debtors to discharge their liabilities to appellant. The analytical approach was to prepare pro forma balance sheets assuming that all assets were disposed of at their fair market value and that the proceeds were used to pay all liabilities. The analysis may be summarized as follows: In 1971 the sole asset of Cordova Lodge, Inc. was offered for sale at $700,000. A sale at this price would have generated sufficient funds to pay off all liabilities, including $288,306 payable to Cordova Village, Inc. ,and $1,073 payable to appellant. The funds received by Cordova Village, Inc. would have been sufficient to pay all its liabilities including the $70,904 owed to appellant, Based on a pro forma liquidation, Rancho Cordova Corp. would have had sufficient funds to pay off all liabilities, exclusive of stockholder liabilities, including the $106,732 payable to appellant.

Notes to appellant's audited balance sheet also indicated that these three debts were personally guaranteed by Mr. Alan T. Olson. Mr. Olson was president of appellant and owned 50 percent of its stock. The remaining 50 percent of appellant's stock was owned by Mr. Olson's wife. In addition, Mr. Olson and his wife owned a one-third interest in each of the three debtor corporations. The record contains no evidence of Mr. Olson's financial standing, nor does it indicate that any effort was made against Mr. Olson to satisfy the indebtedness.

Based on the foregoing audit analysis, appellant has formulated the following argument: During the income year ended May 31, 1972, the debtors' financial condition did not change. Therefore, the three debts

continued to have value. With respect to the first appeal year, Rancho Cordova Corp. lost certain real estate through formal repossession proceedings. Based on a pro forma liquidation of Rancho Cordova Corp., and assuming the facts disclosed in the audit remained unchanged with respect to the other two debtors, there would have been sufficient funds to discharge approximately $34,000 of the liability due to appellant from Rancho Cordova Corp. Consequently, $72,000, representing the remaining liability due appellant from Rancho Cordova Corp., was added to appellant's reserve for bad debts. In the second appeal year, Rancho Cordova Corp. lost additional real property through foreclosure. Assuming-the facts remained unchanged with respect to the other two debtors, there would have been sufficient funds to satisfy only $20,000 of the total original liability of $106,000 owed to appellant. Accordingly, $14,000 due from Rancho Cordova Corp. was added to appellant's reserve. In the final appeal year, Cordova Lodge was sold for $560,200, substantially below the $700,000 original asking price. Cordova Lodge, Inc. was sued for commissions due on the sale of Cordova Lodge. Additionally, Cordova Village, Inc. owed approximately $73,000 in back federal and state taxes. Under these circumstances, approximately $90,000, representing the remainder-of the indebtedness, was added to appellant's reserve.

Respondent* s computation of a reasonable addition to the reserve for bad debts started with an application of the Black Motor Co. six-year moving average formula. Application of this formula produced a reasonable bad debt reserve of $10,199, $9,872 and $5,397, respectively, for the three appeal years. Each of these amounts was less than the $15,000 reserve balance at the commencement of the appeal period. Nevertheless, in an attempt to give effect to appellant's concern *over* the three Cordova accounts, respondent allowed additions. to the bad debt reserve of $21,971 and $27,078 in the years ended in 1973 and 1974, respectively. This adjustment resulted in reserve account balances of $36,318, $58,394, and $58,394 for the years ended in 1973, 1974, and 1975, respectively. Appellant's additions to the reserve, on the other hand, would have produced reserve account balances of $109,000, $150,000, and $222,276, respectively, for the three appeal years. Appellant's actual bad debts for the same three years were only

$653, $5,002, and 0. During the same years, appellant's receivables totaled $252,443, $355,097, and $355,553.

Although past loss experience is the primary guide in determining a reasonable addition to the reserve, it does not follow that known circumstances affecting a particular debt can be ignored. The extent of a reasonable reserve should depend upon an adjustment between known circumstances and experience. (Calavo, Inc., v. Commissioner, supra, 304 F.2d at 654.) It is precisely in making this adjustment that respondent's discretion operates. The question for our determintion is whether the result amounts to an abuse of discretion. As we have stated, the burden of establishing such abuse falls heavily upon appellant.

In determining a proper addition to the reserve, respondent, starting with appellant's past loss experience, applied the court-approved six-year moving average formula of Black Motor Co. which indicated that no addition to the reserve was appropriate. Respondent, nevertheless, concluded that, based on the dubious worth of the three Cordova accounts,, a very substantial addition to the 'reserve was appropriate for two of the three appeal years. Under these circumstances, based on the record before us, we cannot conclude that respondent abused its statutory discretion. Our conclusion is strengthened by the fact that there is no evidence of the financial worth of the guarantor, or that appellant pursued any of its remedies against the guarantor during the appeal years.

Appellant also contends that, separate and apart from the additions to the bad debt reserve, a bad debt deduction should also be allowed for unusual debts becoming worthless during the appeal years. More specifically, relying on Revenue Ruling 74-409 (1974-2 Cum. Bull. 61), appellant argues that only normal losses that arise in the ordinary course of a taxpayer's business are handled through the reserve; " [a] loss that is rare and unpredictable in nature and in amount that does not arise out of a taxpayer's normal day-to-day operations is not charged to the reserve account" but is specifically deducted.

The initial flaw in appellant's argument is that there is nothing unusual or rare in the nature of these accounts which apparemtly arose in the ordinary course of appellant's busines's. The record indicates

that these accounts were generated by appellant's day to-day operations. More importantly, as we have stated above, there is no evidence of any adverse financial conditions affecting the guarantor of the three debts in question. A guaranteed debt is not worthless in the absence of evidence showing the guarantor to be insolvent, or otherwise unable to pay the guaranty. (Cf. Richard M. Fox, 15 B.T.A. 774 (1929); National Farmers Bank, 6 B.T.A. 138 (1927).) For these reasons appellant's argument must be rejected.

For the reasons discussed above, we conclude that appellant has failed to establish that respondent abused its statutory discretion by reducing the claimed additions to appellant's bad debt reserve for the years in question. Accordingly, respondent's action must be sustained.

Appeal of Brighton Sand and Gravel Company

ORDER

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 Brighton Sand and Gravel Company against proposed assessments of additional franchise tax in the amounts of $1,679, $1,209, and $6,505 for the income years ended May 31, 1973, 1974, and 1975, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 19th day of August, 1981, by the State Board of Equalization, with Board Members Mr. Dronenburg, Mr. Nevins and Mr. Bennett present.

rnest J. Dronenburg, Jr., Chairman

Richard Nevins, Member

William M. Bennett, Member

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