



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
PRECISION BRAKE AND WHEEL)

Appearances:

For Appellant: Harry Bundy
Certified Public Accountant,

For Respondent: John A. Stilwell, Jr.
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 Precision Brake and Wheel against a proposed assessment of additional **franchise** tax in the amount of \$833 for the income year ended October 31, 1978.

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The question presented by this appeal is whether respondent properly determined a reasonable addition to appellant's bad debt reserve..

Appellant is an accrual basis taxpayer that has elected the reserve method of accounting for its bad debts. On its franchise tax return for the income year ended October **31, 1978**, appellant deducted \$13,990 as an addition to its reserve for bad debts. Respondent recomputed appellant's bad debt reserve using a six-year moving average and determined that a reasonable addition to appellant's bad debt reserve was \$4,737. A notice of proposed assessment was issued disallowing the \$13,990 addition deducted by appellant and allowing the addition computed by respondent, resulting in a net disallowance of \$9,253.

Revenue and Taxation Code section 24348, subdivision (a), 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. [Emphasis added.]

This section allows deductions for additions to a bad debt reserve only in the discretion of the Franchise Tax Board. Internal Revenue Code section **166(c)**, the federal counterpart to section 24348, grants the Commissioner of Internal Revenue the same discretion. It has been consistently held that the taxpayer bears the heavy burden of proving that respondent (or the Commissioner) abused its discretion in its determination of a "reasonable" addition; that is, the taxpayer must show not only that his computation is reasonable, but also that respondent's computation is unreasonable and arbitrary. (Thor Power Tool Co. v. Commissioner, 439 U.S. 52.2, **547-548** [58 L.Ed.2d 78511979]; Appeal of H-B Investment, Inc., Cal. St. Bd. of Equal., **June 29, 1982.**)

The Franchise Tax Board used the six-year moving average formula of Black Motor Co., 41 B.T.A. 300 (**1940**), affd. on other grounds, 125 **F.2d** 977 (6th Cir. 1942). Both the federal courts and this board have approved this method of determining a reasonable addition to a bad debt reserve. (See Thor Power Tool Co. v. Commissioner, supra, 439 U.S. at 548-549; Appeal of Brighton Sand and Gravel Company, Cal. St. Bd. of Equal., **Aug. 19, 1981.**)

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In support of its position, appellant has stated that it "is subject to substantial losses as evidenced by the losses reflected in the following year." (App. Br.) However, "[w]hat constitutes a reasonable addition to a reserve for bad debts shall be determined in the light of the facts existing at the close of the income year of the proposed addition." (Former Cal. Admin. Code, tit. 18, reg. 24348(g), **subd. (2)(A)** (repealer filed September 3, 1982, Register 82, No. 37).) Subsequent events are merely considered as evidence tending to show the reasonableness or unreasonableness of the taxpayer's method of computing its additions. (Roanoke Vending Exchange, Inc., 40 T.C. 735, 741 (1963).) Appellant's actual net bad debts written off were 4.66 percent, 6.21 percent, and 4.25 percent of its receivables for the income years ended in 1977, 1978, and 1979, respectively. Therefore, the ratio of actual bad debts to receivables declined in the subsequent year (1979). The reserve balances for those same years amounted to 9.65 percent, 9.48 percent, and 5.43 percent of receivables, respectively, well above the actual bad debt experience for those years. These figures tend to show the unreasonableness of appellant's method rather than its reasonableness.

Appellant also states that its gross receivables increased between the income years ended in 1977 and 1978, that it has maintained its reserve on a consistent basis, and that it considers its 1978 addition to be reasonable. **While** we do not doubt any of these statements, none of them show that respondent's determination was unreasonable or arbitrary. Appellant having failed to **carry its** burden of proof, we must sustain respondent's action.

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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 Precision Brake and Wheel against a 'proposed assessment of additional franchise tax in the amount of \$833 for the income year ended October 31, 1978, be and the same is hereby sustained.

Done at **Sacramento**, California, this 17th day of January , 1984, by the State Board of Equalization, with Board Members **Mr.** Nevins, Mr. Dronenburg and **Mr.** Bennett present.

Richard Nevins - - - , Chairman
Ernest J. Dronenburg, Jr. , Member
William M. Bennett , Member
_____, Member
_____, Member