



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
NATIONAL INSTITUTE OF NUTRITION, INC.)

For Appellant: Robert J. Gentile
Certified Public Accountant

For Respondent: Kathleen M. Morris
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 National Institute of Nutrition,, Inc., against proposed assessments of additional franchise tax in the amounts of \$543 and \$3,888 for the income years ended April 30, 1977, and April 30, 1978, respectively.

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Two issues are presented in this appeal. The first issue is whether respondent abused its statutory discretion by reducing appellant's claimed additions to its bad debt reserve. The second issue is whether appellant should be allowed to deduct a claims reserve fund established for anticipated liabilities.

Appellant is a California corporation which *reports* its income on *an* accrual basis. Respondent *con-*ducted an audit of appellant's tax returns for the income years ended on April 30 for each of the years 1977 through 1979. Appellant had elected the reserve method for accounting for its bad debts, and the audit included an examination of the bad debt reserve. Respondent found that **appellant had** no method for computing its bad debt reserve, so respondent utilized the method established by the court in *Black Motor Co.*, 41 B.T.A. 300 (1940), *affd.*, 125 F.2d 977 (6th Cir. 1942). Using this six-year moving average formula, respondent determined that appellant's average bad debt loss for the 1974 to 1979 income years, inclusive, amounted to 1.1312 percent of its average outstanding notes and accounts receivable for those six years. This average loss percentage was applied to \$435,563 of notes and accounts receivable outstanding for the income year ended April 30, 1979, which resulted in an allowable reserve of \$4,727. Appellant's reserve at the end of the 1979 income year was \$31,960. Because of this \$27,033 excess, respondent adjusted appellant's reserve additions made during the income years ended in 1977 and 1978. Respondent disallowed \$21,000 of appellant's bad debt reserve for **the income** year ended in 1977, and disallowed \$6,033 of appellant's bad debt reserve for the income year ended in 1978. No additions were made to the reserve for the *income* year ended in 1979, so this income year was not affected.

Appellant contends that the additions were justified because of its increase in business and outstanding debts. Appellant further contends that there were numerous debts during the two years in question which respondent failed to consider to be worthless debts.

The second issue presented in this appeal involves a claims reserve fund. Appellant is a pharmaceutical manufacturer, which in the course of its business purchased yeast for use in the manufacture of various Vietnamese products. Appellant, subsequent to the manufacture of the products, learned that the yeast

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was contaminated and recalled the products. A lawsuit was instigated by appellant against its supplier in which damages totaling \$71,646 were claimed. Appellant eventually settled for \$58,000, which was approximately the amount appellant had paid the supplier for the raw yeast. On its return for the income year ended April 30, 1978, appellant claimed a \$22,204 deduction as a claims reserve to cover anticipated liabilities to its customers resulting from the recall of the yeast products and to cover the cost of replacing the products. The amounts claimed also covered appellant's legal costs and analytical services. Respondent disallowed the deduction on the basis that the liability was not fixed.

Section 24348 of the Revenue and Taxation Code, which is substantially similar to Internal Revenue Code section 166, allows as a deduction debts which become worthless within the income year or, in the discretion of respondent, a reasonable addition to a reserve for bad debts. By choosing to use the reserve method, appellant has subjected itself to the reasonable discretion of respondent. (See Rev. & Tax. Code, § 24348, subd. (a); Union National Bank & Trust Co. of Elgin, 26 T.C. 537 (1956).) Because of this express statutory discretion, the burden of proof which appellant must carry to overcome such a determination by respondent is greater than the usual burden. Appellant must do more than demonstrate that its additions to the reserve were reasonable. Appellant must also show that respondent's actions in disallowing the additions were arbitrary and amounted to an abuse of discretion. (Appeal of Vaughn F. and Betty F. Fisher, Cal. St. Bd. of Equal., Jan. 7, 1975; Roanoke Vending Exchange, Inc., 40 T.C. 735 (1963).)

Respondent utilized the six-year moving average formula which was set out by the court in Black Motor Co., supra, and approved by the United States Supreme Court in Thor Power Tool Co. v. Commissioner, 439 U.S. 522 [58 L.Ed.2d 785] (1979). ~~This formula~~ applies the taxpayer's own experiences with losses in prior years and establishes a percentage level for the reserve in determining the need for and amount of a current addition.. Appellant has not shown that respondent's use of the **six-year** moving average formula was arbitrary or amounted to an **abuse** of discretion. Consequently, we must conclude that respondent's actions were proper. The increase in appellant's accounts receivable will not make the Black Motor Co. formula inapplicable, as the computations are based upon total year-end reserves and incorporate

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changes in business volume. (Valmont Industries, Inc. v. Commissioner, 73 T.C. 1059 (1980).) Furthermore, appellant has not shown that the accounts, which it alleges became worthless in either the 1977 income year or the 1978 income year did, in fact, become worthless during the years in question. (New York Water Service Corporation, 12 T.C. 780 (1949).)

The second issue in this appeal is whether appellant should be allowed to deduct a claims reserve fund of \$22,204 established for anticipated liabilities.

Revenue and Taxation Code section 24343 provides that a deduction will be allowed for all ordinary and necessary expenses paid or incurred in carrying on a trade or business. The amount of the deduction must be taken for the taxable year which is the proper taxable year under the method of accounting used in computing income. (Rev. & Tax. Code, § 24681, subd. (a).) This section is substantially the same as Internal Revenue Code section 461(a). It is well established that federal precedents are entitled to great weight when construing state law that is comparable to federal law. (Meanley v. McColgan, 49 Cal.App.2d 203 [121 P.2d 45] (1942).) Furthermore, in the present case, respondent has not adopted a regulation which interprets or defines what is the proper year of deduction. The federal government, however, has adopted Treasury regulation 1.461-1(a) which, in interpreting Internal Revenue Code section 461(a), does set forth the general rule for determining the year of deduction. In the absence of a Franchise Tax Board regulation, this federal regulation governs the interpretation of Revenue and Taxation Code section 24681, the California counterpart of section 461.

Appellant established a claims reserve fund of \$22,204 to cover anticipated reimbursements to its customers and to settle any lawsuits from individuals using the products. The reserve was also to cover appellant's cost in replacing the products. This amount was established in the following manner:

Original claim filed against supplier	
plus amount of claim by Eden Rand	\$71,646
Amount accepted in settlement	<u>.-58,000</u>
Subtotal	\$19,285
Estimate of additional anticipated expenses	<u>2,919</u>
Claims reserve fund total	<u>\$22,204</u>

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In support of its position that the liability is fixed, appellant relies on Treasury regulation **1.461-1(a)(2)** which provides:

Under an accrual method of accounting, an expense is **deductible** for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy While no accrual shall be made in any case in which all of the events have not occurred which fix **the liability**, the fact that the exact amount of the liability which has been incurred cannot be determined will not prevent the accrual within the taxable year of such part thereof as can be computed with **reasonable** accuracy. (Emphasis added.)

The courts, in applying this regulation and utilizing the "all events" test, have held that both prongs of the test must be met. First, all events establishing the fact of liability must have occurred. Secondly, the amount of the liability must be determinable with reasonable accuracy. (Supermarkets General Corp. v. United States, 537 F.Supp. 759, 761 (D. N.J. 1982).)

Appellant contends that it has met the requirements of the first part of the test as the contaminated yeast was purchased and sold by them during the income year ending April 30, 1978. We cannot agree. Appellant has not shown that it incurred an irrevocable or certain obligation to pay any of its customers or to pay any individual who may have eventually been harmed by the yeast products. When there are contingencies surrounding the payment of any claim, the reserve cannot meet the first prong of the "all events" test. (See Gateway Transport Co., Inc. v. United States, 39 Am.Fed.Tax R.2d 77-647 (1976).) In the present case, there is no evidence that appellant was in any way responsible for the contaminated yeast or any injury it may have caused.

As to the second part of the test, we cannot, conclude that appellant could have determined with any reasonable accuracy the number of claims from individuals or the amounts of each claim. For example, one of appellant's customers indicated that they had received back 2,015 bottles of B Complex with Vitamin C tablets-containing the contaminated yeast and that they estimated they could get back 24 additional bottles. There is no evidence as to whether these contaminated bottles were

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unopened bottles or whether-the bottles had been **opened and consumed** by various individuals, **thus creating a potential** lawsuit.

In sum, we must. conclude that respondent acted properly in disallowing a deduction for the claims reserve fund as **appellant** has not met the two requirements set out in the "all events" test.

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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 protest of National Institute of Nutrition, Inc., against proposed assessments of additional franchise tax in the amounts of \$543 and \$3,888 for the income years ended April 30, 1977, and April 30, 1978, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 1st day of August, 1984, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Dronenburg, Mr. Collis, Mr. Bennett and Mr. Harvey present.

<u>Richard Nevins</u>	, Chairman
<u>Ernest J. Dronenburg, Jr.</u>	, Member
<u>Conway H. Collis</u>	, Member
<u>William M. Bennett</u>	, Member
<u>Walter Harvey*</u>	, Member

*For Kenneth Cory, per Government Code section 7.9