

BEFORE THE STATE BOARD OF **EQUALIZATION**
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
WESTERN MEDICAL, LTD.)

For Appellant: B. Andrew Chapkis
Certified Public Accountant

For Respondent: George Bond
Counsel

O P I N I O N

This appeal is made pursuant to section 18593 of the Revenue and Taxation Code from the **action** of the Franchise Tax Board on the protest of Western Medical, Ltd., against proposed assessments of **additional franchise tax** in the amounts of \$252.66, \$568.30, and \$262.86 for the income years ended May 31, 1980, May 31, 1981, and May 31, 1982, respectively.

Appeal of Western Medical, Ltd.

The question presented by this appeal is whether appellant has shown that it was entitled to use the reserve method of accounting for its bad debts during its income years ended in 1980, 1981, and 1982.

Appellant was incorporated as a California corporation on October 13, 1977. It had previously been a sole proprietorship.

No bad debt deductions were claimed on appellant's first franchise tax return, for the short income year ended May 31, 1978, nor on its original return for the income year ended May 31, 1979. However, appellant later filed an amended return for the latter year, claiming a bad debt expense deduction of \$20,859. There was no mention made of a bad debt reserve or an addition to a bad debt reserve.

On appellant's return for the income year ended May 31, 1980, appellant claimed a bad debt deduction of \$12,491. It also completed Schedule F, for bad debt reserves, showing an addition to a bad debt reserve of \$3,641, charges against the reserve of \$905 and a balance in the reserve of \$2,736. The returns for the years ended in 1981 and 1982 also showed additions to a bad debt reserve which were deducted.

Respondent determined that appellant had elected to use the specific charge-off method of accounting for its bad debts in the years preceding those now on appeal, that it had never requested or been granted the right to change to the reserve method, and, consequently, that it could not use the reserve method of accounting for its bad debts. Respondent, therefore, disallowed appellant's claimed bad debt deductions to the extent that they exceeded the amounts which actually became worthless in each of the appeal years. Appellant contends that it has always used the reserve method of accounting for its bad debts and, therefore, the bad debt deductions should have been allowed as claimed.

Revenue and Taxation Code section 24348 allows a taxpayer to take a deduction for debts which actually become worthless during the income year (the specific charge-off method), "or, in the discretion of the Franchise Tax Board, a reasonable addition to a reserve for bad debts." Respondent's determination regarding additions to a bad debt reserve is entitled to great weight because of the express discretion granted by the statute. Therefore, the taxpayer's burden of proof is

Appeal of Western Medical, Ltd.

heavier than that usually required to overturn a deficiency assessment. The taxpayer must not only show that additions to the reserve were reasonable, **but** also that respondent's action in disallowing those additions was arbitrary and amounted to an abuse of discretion.

(Appeal of H-B Investment, Inc., Cal. St. Bd. of Equal., June 29, 1982; Appeal of Brighton Sand and Gravel Company, Cal. St. Bd. of Equal., Aug. 19, 1981.)

The regulations under section 24348, in effect for the income years on appeal, provided, in pertinent part:

A taxpayer filing a return of income for the first income year for which it is entitled to a bad debt deduction may select either of the two methods prescribed by [Revenue and Taxation Code section 24348] for treating bad debts, but such selection is subject to the approval of the **Franchise Tax** Board upon examination of the return. If the method so selected is approved, it shall be used in returns for all subsequent income years unless the Franchise Tax Board grants permission to use the other method.

(Former Cal. Admin. Code, tit. 18, reg. 24348(d), subd. (2)(A), repealer filed Sept. 3, 1982 (Register 82, No. 37).)

Another of the regulations under this section provided:

A taxpayer who has established the reserve method of treating bad debts and has maintained proper reserve accounts for bad debts or who, in accordance with subsection (2) of Reg. 24348(d), adopts the reserve method of treating bad debts may deduct from gross income a reasonable addition to a reserve for bad debts in lieu of deducting specific bad debt items.

(Former Cal. Admin. Code, tit. 18, reg. 24348(g), subd. (1), repealer filed Sept. 3, 1982 (Register 82, No. 37).)

Appellant has argued that it has always used the reserve method of accounting for its bad debts and has provided copies of general ledgers to show this. However, the ledgers show only an entry titled "Allowance

Appeal of Western Medical, Ltd.

for Bad Debt," with no balance entry. (App. Ex. A & B.) We do not find this the type of evidence which convinces us that appellant "established the *reserve* method . . . and . . . maintained proper reserve accounts for **bad** debts . . ." as required- by former **regulation** 24348(g), subdivision (1), supra.

The other method which allows a taxpayer to use the reserve method is the election of that method. This election must be made on the return "for the first income year for which [the taxpayer] is entitled to a bad debt deduction . . ." (Former Cal. Admin. Code, tit. 18, reg. 24348(d), **subd.** (2)(A), supra.)

The first year that appellant was entitled to claim a bad **debt deduction** was the income year ended May 31, 1979. On its amended return for that year, appellant claimed a "bad debt expense" of \$20,859 and did not attach the schedule required for additions to bad debt **reserves**. We do not think it was arbitrary or unreasonable for respondent to conclude from this that appellant had elected the specific charge-off method at that time. Therefore, when appellant attempted to deduct additions to a bad debt reserve during the years on appeal without having been granted permission to change its method of accounting for bad debts, it was not an abuse of discretion for respondent to disallow those additions to the extent that they exceeded appellant's actual bad debt expense for those years.

Appellant having failed to carry its burden of proof, we must sustain respondent's action.

Appeal of Western Medical, Ltd.

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 18595 of the Revenue and Taxation Code,, that the action of the Franchise Tax Board on the protest of Western Medical, Ltd., against proposed assessments of additional franchise tax in the amounts of \$252.66, \$568.30, and \$262.86 for the income years ended May 31, 1980, May 31, 1981, and May 31, 1982, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 14th day of November, **1984**, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Dronenburg, Mr. Collis and Mr. Bennett present.

Richard Nevins , Chairman

Ernest J. Dronenburg, Jr. , Member

Conway H. Collis, Member

William M. Bennett

Member