

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
AIR CONDITIONING SALES, INC.) No. 84A-505

For Appellant: Lester H. Leas

For Respondent: Patricia Hart
Counsel

O P I N I O N

This appeal is made pursuant to section 25666^{1/} of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Air Conditioning Sales, Inc., against a proposed assessment of additional franchise tax in the amount of \$2,700 for the income year ended October 31, 1979.

^{1/} Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the income year in issue.

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debt reserve. Appellant was assessed accordingly and this appeal followed.

A bad debt reserve is an accounting method for absorbing debts reasonably expected to become worthless within the upcoming year. (Roanoke Vending Exchange, Inc. v. Commissioner, 40 T.C. 735 (1963).) If at the current year's end the reserve balance is sufficient to absorb bad debt losses expected in the upcoming year, then no addition is allowed for the current taxable year. (Roanoke Vending Exchange, Inc. v. Commissioner, supra.) A taxpayer cannot stockpile a bad debt reserve for use in subsequent years in anticipation of some undefined contingency. (Appeal of Victorville Glass Co., Inc., Cal. St. Bd. of Equal., Oct. 26, 1983.)

Respondent's authority to oversee appellant's use of the reserve method of accounting for bad debts comes from section 24348, subdivision (a), which provides that "[t]here 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." Section 24348 is substantially similar to Internal Revenue Code section 166. Consequently, the determinations of federal courts construing a federal statute are entitled to great weight in interpreting a state statute based on a federal statute. (Meanley v. McColgan, 49 Cal.App.2d 203 [121 P.2d 45] (1942).)

By its election to use the reserve method for deducting bad debts, appellant has chosen to subject itself to the reasonable discretion of respondent. (Union National Bank and Trust Co. of Elgin v. Commissioner, 26 T.C. 537, 543 (1956); Appeal of Livingston Bros., Inc., Cal. St. Bd. of Equal., Oct. 16, 1957.) Because of the express statutory discretion given respondent, the burden of proof on appellant in overcoming a determination by respondent is greater than the usual burden facing one who seeks to overcome the presumption of correctness which attaches to an ordinary notice of deficiency. As a result, the taxpayer must not only demonstrate that its additions to the reserve were reasonable, but also must establish that respondent's actions in disallowing these additions were arbitrary and amounted to an abuse of discretion. (Appeal of H-B Investments, Inc., Cal. St. Bd. of Equal., June 29, 1982; Appeal of Brighton Sand and Gravel Company, Cal. St. Bd. of Equal., Aug. 19, 1981.)

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Consequently, a formula, like the one used by appellant, will only produce a satisfactory result where a relative consistency has emerged in the pattern of the taxpayer's bad debt losses and there is a correlation between those losses and the balance in the reserve. (Westchester Development Co. v. Commissioner, 63 T.C. 198 (1974).) Therefore, the mere fact that appellant has been using this system for a number of years and respondent has not previously objected to its use is irrelevant. (Roanoke Vending Exchange, Inc. v. Commissioner, supra.)

Through the use of its formula, appellant's reserve remained at a level that was approximately 10 percent of its accounts receivable from its income year 1974 through the income year at issue. During that same time period, the charge-offs against the reserve fluctuated between .5 and 2.5 percent of the accounts receivable. Appellant's history shows that its formula produced a balance in the reserve that was much greater than was necessary to absorb the debts that did go bad during that period. Accordingly, the consistency and amount of bad debt losses needed to justify such a large reserve based upon a set formula is lacking in this case. Consequently, a rigid adherence to its formula during the year at issue cannot be justified by appellant's past history.

In an attempt to bolster its formula and, thereby, its addition for income year 1979, appellant states that a review of its troubled accounts substantiated the need for an even higher reserve than its formula determined. Appellant cites three factors it considered when it determined that an account was troubled: (1) the age of the account; (2) financial strength of the account; and (3) the ability of the account's management. Appellant also points out that many of the accounts it reviewed eventually became worthless in the following years.

Specific information that the collection of certain accounts is doubtful may justify a larger reserve requirement than respondent's determination would allow. (Appeal of Pringle Tractor Co., Cal. St. Bd. of Equal., Mar. 7, 1967.) The mere aging of accounts, however, is not, by itself, enough to overcome respondent's determination. (Thor Power Tool Co. v. Commissioner, supra; United States v. Haskel Engineering & Supply Co., 380 F.2d 786 (9th Cir. 1967); Rev. Rul. 76-362, 1976-2 C.B. 45.) A taxpayer must be able to point to specific conditions that would cause future debt collections to be less likely to occur than in the past. (Thor Power Tool Co. v. Commissioner, supra.)

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was not adequate to offset losses reasonably to be anticipated from such increased sales. Indeed, in the past, its reserve for bad debts has substantially exceeded actual losses sustained. Thus, the petitioner has completely failed to show that a reserve . . . as permitted by the Commissioner . . . was not sufficient to offset anticipated losses; accordingly, we hold that the petitioner has failed to prove that the Commissioner abused his discretion in disallowing deductions for additions to the reserve [for the years at issue] (Emphasis added.)

We reiterate that part of appellant's "heavy burden" is that it must show that its own addition is reasonable. By failing to show that its reserve balance at the end of the income year 1979 was inadequate to absorb those debts reasonably expected to become uncollectable in the income year 1980, appellant has not carried this part of its burden. Accordingly, respondent's action in this matter will be sustained.