BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of	)	
	)	No. 84A-527
GROSH SCENIC STUDIOS, INC.	)	

For Appellant: William L. Feinstein
Attorney at Law

For Respondent: Paul J. Petrozzi
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 Grosh Scenic Studios, Inc., against a proposed assessment of additional franchise tax in the amount of $3,800 for the income year ended June 30, 1981.

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.

The issue presented in this appeal is whether respondent abused its statutory discretion by reducing the claimed additions to appellant's bad debt reserve for the income year ended June 30, 1981.

Appellant is a California corporation engaged in the manufacture of stage and scenic equipment. Appellant uses the accrual accounting method and accounts for its bad debt losses by maintaining a reserve for bad debts.

In the income year in issue, appellant claimed an addition of $39,580 to its bad debt reserve. This figure allegedly was based upon appellant's determination that the following accounts receivable were not collectable:

Attco, Inc.	$ 8,890
Palace Disco	42,083
Woburn Studios	12,010

(Appellant has provided no explanation of why only $39,580 of the above-listed accounts receivable was claimed.)

The charge off from Attco, Inc., represents a four percent tax imposed by the state of Hawaii on work appellant performed for Attco in Hawaii. Appellant contends that the tax was imposed on both Attco and appellant. Appellant further contends that because appellant had no assets in Hawaii, Attco was forced to pay the tax. In return, Attco deducted the $8,890 in tax from the amount it owed appellant. Appellant considered this amount to be a bad debt as it is of the opinion that Attco should have paid the tax. In any event, because appellant wanted to retain Attco as a customer, it wrote off the disputed amount.

The bad debt with respect to Palace Disco represents a receivable for work done for Palace Disco for which they did not take delivery, plus past due interest. Appellant contends that because the goods were never delivered, there is a question as to how much, if any, a court would award appellant if it attempted to collect this amount. Consequently, appellant made no attempt at collection.

The bad debt amount from Woburn Studios represents an amount charged by appellant for installation of a turntable which appellant never installed. Woburn Studios had, according to appellant, ordered three turntables but, because of property use restrictions, was

only allowed to use two of them. Woburn Studios paid for the materials on all three turntables and for the installation of two turntables. The $12,010 shown as a bad debt represents that portion of an account receivable created for the installation of the third turntable, which installation was never performed by appellant. Appellant contends that since it never performed the work, it may have been improper to have created the account receivable in the first place but that the amount should be characterized as a bad debt. Because appellant wanted to keep Woburn Studios as a client, it wrote off the $12,010.

Respondent determined that no addition to the bad debt reserve was justified, disallowed the entire amount, and issued a proposed assessment. Appellant contends that it has met its burden of showing that the addition to its reserve is reasonable. Appellant further contends that respondent has acted unreasonably in applying the Black Motor formula.

Subdivision (a) of section 24348 provides: "(a) 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."

This language is substantially the same as that of Internal Revenue Code section 166(c). Consequently, federal precedent is persuasive in interpreting section 24348. (Meanley v. McColgan, 49 Cal.App.2d 203 [121 P.2d 45] (1942).)

As we have noted in previous opinions, respondent's determinations with respect to additions to a reserve for bad debts carry great weight because of the express discretion granted it by statute. When the Franchise Tax Board disallows an addition to a reserve for bad debts, the taxpayer must not only demonstrate that additions to the reserve were reasonable, but also must establish that respondent's actions in disallowing those additions were arbitrary and amounted to an abuse of discretion. (Roanoke Vending Exchange, Inc. v. Commissioner, 40 T.C. 735 (1963); Appeal of Brighton Sand and Gravel Company, Cal. St. Bd. of Equal., Aug. 19, 1981; Appeal of Vaughn F. and Betty F. Fisher, Cal. St. Bd. of Equal., Jan. 7, 1975.) In other words, by choosing to use the reserve method, appellant has subjected itself to the reasonable discretion of respondent.

(Union National Bank & Trust Co. of Elgin v. Commissioner, 26 T.C. 537 (1956).)

A bad debt reserve is essentially an estimate of future losses which can reasonably be expected to result from debts outstanding at the close of the taxable year. (Valmont Industries, Inc. v. Commissioner, 73 T.C. 1059 (1980).) Under the reserve method of handling bad debts, the reserve is reduced by charging against it specific bad debts which become worthless during the income year and is increased by crediting it with reasonable additions. What is reasonable 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.

Respondent utilized the six-year moving average formula which was set out by the court in Black Motor Co. v. Commissioner, 41 B.T.A. 300 (1940), affd., 125 F.2d 977 (6th Cir. 1942), 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. Appellant contends that because it is a contractor and has sales which fluctuate from year to year, the Black Motor formula should not be applied. We do not agree. It is well established that if a taxpayer's most recent bad debt experience is unrepresentative for some reason, a formula using that experience as data cannot be expected to produce a "reasonable" addition for the current year. (Thor Power Tool Co. v. Commissioner, supra.) In this case, appellant has not shown either changes in conditions of business in general or changes in customers specifically. Unless appellant can point to conditions that will cause future debt collections to be less likely than in the past, we cannot conclude that the Black Motor formula is unreliable.

As was stated above, when the Franchise Tax Board disallows an addition to a reserve, the taxpayer must not only establish that respondent's actions in disallowing the additions were arbitrary, but the taxpayer must also establish that the additions to the reserve were reasonable. Here, we must conclude that appellant has failed on both requirements.

Appellant's basis for increasing its bad debt reserve is the alleged "bad debts" from Woburn Studios, Palace Disco, and Attco, Inc. Whether it is reasonable to consider these accounts in computing appellant's bad debt reserve depends on whether the accounts are, in fact, bad debts. If the losses are not bad debt losses, then appellant is not entitled to the special treatment provided by section 24348, subdivision (a). (See Appeal of Wright Way Mobile Homes, Inc., Cal. St. Bd. of Equal., May 4, 1983.)

Appellant has stated that as to the Attco account, the amount involved represented a tax imposed by the state of Hawaii on both Attco and appellant. There has been no evidence presented that this amount was a debt owed to appellant by Attco. Rather, it appears that instead of resolving the issue of who was responsible for the tax, appellant chose to pay Attco, who had already paid the state of Hawaii, and therefore retain Attco as a satisfied customer. Finally, there is no evidence that even if the amount were a bad debt, that the debt was worthless within the period at issue. (Rev. & Tax. Code, § 24348.)

As to the amount involving Palace Disco, the goods were never delivered. Appellant has stated that there is a question as to how much, if any, a court would award appellant if it tried to collect this amount. Because the amount of and the validity of this alleged debt are in question, we cannot conclude that the amount involving Palace Disco is a debt that became worthless in the period at issue. (See Appeal of Bay Area Financial Corporation, St. Bd. of Equal., Apr. 5, 1984.)

Finally, the amount involving Woburn Studios represents an amount charged by appellant for a turntable that was never installed. Because appellant wanted to keep Woburn Studios as a client, it considered the amount a bad debt. Once again, appellant has submitted no evidence that this amount is a valid debt that became worthless during the period in issue.

For the reasons discussed above, we conclude that appellant has failed to establish that respondent abused its statutory discretion by disallowing the claimed addition to appellant's bad debt reserve and that appellant has not shown that its additions to its bad debt reserve were reasonable.

Appeal of Grosh Scenic Studios, Inc.

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 Grosh Scenic Studios, Inc., against a proposed assessment of additional franchise tax in the amount of $3,800 for the income year ended June 30, 1981, be and the same is hereby sustained.

Done at Sacramento, California, this 10th day of September, 1985, by the State Board of Equalization, with Board Members Mr. Dronenburg, Mr. Nevins and Mr. Harvey present.

Ernest J. Dronenburg, Jr., Chairman

Richard Nevins, Member

Walter Harvey*, Member

_____, Member

_____, Member

*For Kenneth Cory, per Government Code section 7.9