

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

In the Matter of the Appeal of)
CHOE MEAT COMPANY)

For Appellant: Harold Choe
President

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 Choe Meat Company against proposed assessments of additional franchise tax in the amounts of \$859 and \$1,441 for the income years ended September 30, 1979, and September 30, 1980, respectively.

1/ Unless otherwise specified, all section references ~~are to~~ sections of the Revenue and Taxation Code as in effect for the years in issue.

Choe Meat Company

The issue on appeal is whether respondent abused its statutory discretion in disallowing the claimed additions to appellant's alleged bad debt reserve for the years in question..

Appellant is an accrual basis taxpayer whose principal business activity is the wholesale distribution of meat. While conducting an audit of **appellant's** books for the years in question, respondent became confused by appellant's use of what it referred to as its "reserve for bad debts." First, respondent was unable to understand precisely what method appellant employed to determine what its yearly additions to the fund should have been. In an effort to decide if the adjustments for the years at issue were reasonable, respondent attempted to apply to the reserve the **well-known formula** set forth by the **court** in Black Motor Co. v. Commissioner, 41 **B.T.A.** 300 (1940). That formula applies a taxpayer's own experiences with losses in prior years and establishes a percentage level for the reserve in determining the need and amount of a current addition. The **formula**, however, could not properly be applied to appellant's books because the records reflected only additions to the reserve: no bad debts had been charged against the fund during the previous six years,

After the discovery of the lack of bad debt charge-offs against the **reserve**, respondent uncovered another oddity in appellant's reserve method. The balance of the reserve did not grow at a rate consistent with appellant's yearly additions. Some of the yearly additions increased the balance by a fraction of the added amount while other additions did not increase the balance at all.

As respondent was confused by the method appellant employed in implementing its **reserve**, respondent was unable to **agree** with appellant that the additions for the years at issue were reasonable. Respondent reasoned that as nothing indicated that the six-year pattern of bad debt charge-offs against the reserve was expected to change during the years under audit, the 1978 reserve level would have been more than adequate to absorb those debts, if **any**, which were reasonably expected to have become uncollectable during the years in question. Respondent disallowed the additions to the **reserve**, appellant was assessed **accordingly**, and this appeal followed.

Respondent's authority to oversee **appellant's** use of the reserve method of accounting for bad debts

Choe Meat Company

comes from section 24348, which provides, 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."**

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 & 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 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.)

On appeal, appellant attempts to satisfy its burden of proving its reserve was reasonable by showing that the reserve balance never exceeded 2.3 percent of the outstanding receivables during either of the years in question. Appellant further claims that it did suffer from uncollectable bad debts during the years at issue but the debts were incorrectly reported on its tax forms. Appellant **feels**, without any further explanation, that if respondent's determination is upheld, appellant's bad debt losses for those years will be **"completely nullified."** We disagree with **appellant's** analysis.

Appellant's method of accounting for its bad debts by a reserve conforms to no recognized method. 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

Choe Meat Company

of Victorville Glass Co., Inc., Cal. St. Bd. of Equal.,
Oct. 26, 1983.)

Evenafter a careful examination of the **record**, we have been unable to discern how appellant's reserve system operated. We do not know how appellant decided what its yearly reserve balance should have **been**, how it chose the amount it added to the reserve each year, or why its additions to the reserve during the years in question did not increase the balance of the reserve. by the amount of the addition. This latter fact is especially puzzling as **appellant** has not charged off any bad debts against its reserve since at least **1975**. Appellant, at least during the years in question, appears to have written off bad debts directly against current income. Although appellant now claims that **the** deductions from current income were mistakes in its **completion** of the state **franchise** tax forms, appellant's treatment of bad debts as described above appears to have been consistent in its books as well as its tax forms. While it may be that some hybrid form of the reserve and specific charge-off systems was used to account for the bad debts, appellant has failed to provide us with an explanation as to how its system operated. **Without** more information, appellant simply appears to have been stockpiling a reserve by a confusing method for no apparent purpose.

As appellant has not proven it properly used the reserve method of accounting for its bad debts, it has failed to convince us of the reasonableness of its additions to its bad debt reserve. For the reasons discussed above, we conclude that appellant has failed to establish that respondent abused its statutory discretion in eliminating the claimed additions to **appellant's** bad debt reserve for the years in question. Accordingly, **respondent's** action will be sustained.

