



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
PRIME PLASTIC SYSTEMS, INC.) No. **83A-989**

For **Appellant:** Donald F. Bayley
President

For Respondent: David Lew
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 Prime Plastic Systems, Inc., against a proposed assessment of additional franchise tax in the amount of \$1,387 for the income year ended September 30, 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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The question presented by this appeal is **whether** respondent abused its discretion by disallowing appellant's addition to its bad debt reserve for the income year ended September 30, 1979.

Appellant is a California corporation engaged in the business of retail sales of machinery and parts. It uses the accrual method of accounting and has elected to use the reserve method of accounting for its bad debts.

On its return for the income year ended September 30, 1979, appellant deducted **\$14,986.62** as an addition **to** its bad debt reserve. After charging off \$175.37, the balance in its bad debt reserve account was **\$16,475.01**. Respondent examined appellant's return and, using the formula of Black Motor Co. v. Commissioner, 14 B.T.A. 300 (1940), affd., 125 F.2d 977 (6th Cir. 1942), determined that appellant's addition to its bad debt reserve was excessive.

Section 24348, subdivision (a), provided, 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." Similar provisions are found in the federal law. (I.R.C. § 166.)

Respondent's determination with respect to additions to a reserve for bad debts carries great weight because of the express discretion granted it by statute. Accordingly, the taxpayer's burden of proof is greater than that usually applicable to a taxpayer who seeks to **overcome** the presumption of correctness which attaches to respondent's ordinary deficiency assessment. (Roanoke Vending Exchange, Inc. v. Commissioner, 40 T.C. **735, 741** (1963).) The taxpayer must not only demonstrate that additions to the reserve were reasonable, but also that respondent's disallowance of the additions were arbitrary and amounted to an abuse of discretion. (Roanoke Vending Exchange, Inc. v. Commissioner, supra.)

Under the reserve method for handling bad debts, the reserve is reduced by charging against it specific bad debts which become worthless during the year and is increased by crediting it with reasonable additions. The ultimate question concerning the deductibility of an addition is-whether the balance in the reserve is adequate to cover the anticipated losses and not whether the proposed addition is sufficient to cover them. (Appeal o f

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Brighton Sand and Gravel Company, Cal. St. Bd. of Equal.; Aug. 19, 1981.) If the reserve is already adequate to cover the accounts receivable which reasonably can be expected to become worthless, further additions will be considered unreasonable and will not be deductible. (Valmont Industries, Inc. v. Commissioner, 73 T.C. 1059, 1067 (1980).)

A bad debt reserve, because it is established to cover anticipated losses, normally deals "with unknown factors bearing upon unidentifiable accounts," and "its reasonable extent is ordinarily calculated by resort to past experience with such accounts in the composite." (Calavo, Inc. v. Commissioner, 304 F.2d 650, 654 (1962).) Past experience, however, **is** not **the** only factor used in determining the proper addition to a bad debt reserve. Consideration should also be given to the circumstances particularly affecting a specific bad debt when such information is available.

The extent of a reasonable reserve should depend upon an adjustment between known circumstances and experience.

It is in the making of this adjustment that the discretion of (respondent) operates in **cases** such as this. The question . . . is whether the result amounts to an abuse of discretion. . . . **[T]**he burden of establishing such abuse falls heavily upon the taxpayer.

(Calavo, Inc. v. Commissioner, supra.)

The most widely used formula for determining a reasonable addition to a bad debt reserve is that set forth in Black Motor Co. v. Commissioner, supra. That formula **applies** a taxpayer's own average loss experience in prior years and establishes a percentage level for the reserve which determines the need for and amount of a current addition. Appellant's bad debts charged against its reserve in prior years were small, and, using the Black Motor Co. formula, respondent determined that no **additions** to appellant's reserve were necessary for the 1979 income year.

Appellant states that its reserve was established to cover anticipated losses on specific accounts, primarily one account where the balance due was contested by the purchaser because of alleged defects in the machinery purchased. However, the debt was not alleged

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to be worthless during the income year and appellant has presented us with no information which would indicate that the recovery on that account was so uncertain at the end of the 1979 income year that respondent's disallowance of an addition to the reserve to cover it amounted to an abuse of discretion. We must **conclude**, therefore, that appellant has not carried its burden of proof and **respondent's** action must be sustained.

