BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
VAUGHN F. AND BETTY F. FISHER)

For Appellants: Peter F. Fisher

For Respondent: Crawford H. Thomas
Chief Counsel

Paul J. Petrozzi
Counsel

OPINION

This appeal is made pursuant to section 18594 of the Revenue and Taxation Code'from the action of the Franchise Tax Board on the protest of Vaughn F. and Betty F. Fisher against proposed assessments of additional personal, income tax in the amounts of $284.58 and $511.40 for the years 1967 and 1968, respectively.

The issue presented is whether respondent properly disallowed the claimed deductions for bad debts calculated by using an unusual reserve for bad debts method.

Appellant Vaughn F. Fisher owns and operates a sole proprietorship, the Fisher Drug Store. The proprietorship's books are kept on an accrual basis. The facts in the record are meager but they establish that appellant used an irregular method of computing bad debt deductions for the store during the appeal years.

The balance in the reserve at the beginning of 1967 was $3,510.00. When that year ended appellant totaled the amount of accounts receivable 90 days or older and compared them with the amount of such accounts at the end of 1966. As of December 31, 1967, their total exceeded the figure at the end of the prior year by $2,834.00. This amount was deducted as bad debt expense for 1967 and added to the reserve account. A similar comparison was made with respect to the amounts in accounts receivable as of December 31, 1967, and December 31, 1968. The balance at the end of the latter year exceeded the former by $4,967.00. This amount was likewise deducted as bad debt expense for 1968 and credited to the reserve.

Accounts receivable that had, in fact, become worthless in 1967 and 1968 were not written off nor charged against the reserve.[1] Consequently, all accounts 90 days or older at the end of 1966 were included in the total of accounts receivable at the end of 1967, except for interim collections, and were, thereby, some of the "aged" accounts used to measure the bad debt expense and the reserve increase for 1967.[2] In turn, all such accounts not collected in 1968 were included in computing bad debt expense and the reserve addition for that year. As a result of this practice, during the years in issue the balance of accounts receivable continually increased and the bad debt reserve also continued to increase.

In 1969, for the first time, appellant commenced an intensive collection campaign, including legal actions. As a result, collections significantly increased. Consequently, there was a

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1/ Except one $7.75 amount written off in 1967 but it was charged against sales.

2/ With the possible exception contained in footnote 1, if that account had been 90 days overdue at the end of 1966.

decline in the amount of 90 day or older accounts from the end of 1968 through 1969 and 1970. Under appellant's unusual reserve method the decrease in 1969 was treated as a "negative bad debt deduction", increasing income by $4,112.00 for that year, and decreasing the reserve by an identical amount. It is also noted that accounts totaling $897.00 were written off in 1969 but were charged against sales. In like manner, for 1970, income was increased by a "negative bad debt deduction" of $2,370.00, and the reserve decreased by the same amount. There were no write-offs against sales in 1970.

Respondent concluded that appellant's "aging of accounts" method was not a reasonable manner of computing annual bad debt deductions and of accounting for recoveries.

Respondent also found that if a proper reserve method had been used, no addition to the existing reserve of $3,510.00 on the books at the beginning of 1967 should have been made in either 1967 or 1968. This fact was determined by using the years 1967 through 1970 as a test period. Appellant's records were incomplete but, utilizing available information, respondent found that net bad debts for that period totaled $3,779.00. It then computed a bad debts experience ratio by comparing the net bad debts to the sum of the balances of accounts receivable outstanding at the end of each of the four test period years. It determined this latter sum to be $103,510.00. Using these figures, respondent calculated that appellant had a reasonable bad debt experience ratio of approximately 3.7 percent.

Next, respondent allocated the bad debts to specific test period years in the best manner it could with the evidence available. When it wrote off $329.74, the total bad debts it found for 1967, against $3,510.00, the 1967 beginning reserve balance, the remaining reserve figure at the end of 1967 was $3,180.26. Inasmuch as 3.7 percent of the outstanding receivables balance as of December 31, 1967, was $1,049.99, respondent concluded that there would have been no need to add any amount to the reserve account in 1967 if a proper reserve method had been used.3/ When respondent then wrote off $1,398.74, the bad debts

3/ It also disallowed the $7.75 write-off against sales.

it found for 1968, against the reserve balance of $3,180.26, the remaining reserve figure at the end of 1968 was $1,781.52. Since 3.7 percent of the outstanding receivables balance as of December 31, 1968, was $1,255.15, respondent again reasoned that there was no need to increase the reserve account in 1968.

On the other hand, respondent's calculations for 1969 and 1970 disclosed that appellant's reserve was insufficient at the end of each of those years because it did not equal 3.7 percent of the outstanding accounts receivable,, As to those years, respondent concluded that appellant could deduct as bad debt expenses additions to the $3,510.00 reserve to correct the insufficiencies, and also receive credit for the "negative bad debt deductions" it had treated as income. However, appellant's $897.00 write-off against sales in 1969 was disallowed. After these proposed adjustments, appellant was advised of the amount of his overpayment for those years and was urged to file refund claims.

The denial of the bad debt deductions for 1967 and 1968 gave rise to this appeal.

Appellant maintains that his method of computing bad debt deductions was reasonable. He also asserts that respondent made certain errors in its review of the test period: (1) Charging bad debts against the reserve; (2) Not including as bad debts accounts actually worthless earlier in the test period but collected later therein; (3) Understating accounts receivable; and (4) Understating bad debts.

The applicable statutory law provides that in lieu of deducting specific debts which become worthless within the taxable year, the taxpayer is allowed (in the discretion of the Franchise Tax Board) a deduction for a reasonable addition to a reserve for bad debts. (Rev. & Tax. Code, § 17207, subds. (a)(l) and (c).) Similar provisions are contained in the federal law. (Int. Rev. Code of 1954, § 166(a)(l) and (c).) Under such provisions, if the reserve is already adequate to cover the accounts receivable reasonably expected to become worthless, no deduction for an addition to the reserve is allowable for the taxable year. (Roanoke Vending Exchange; Inc., 40 T. C. 735; Lancaster Stone Products Corp., T. C. Memo., June 16, 1969.) Furthermore,

subsequent loss experience may properly be considered as additional evidence tending to demonstrate the unreasonableness of a taxpayer's method of computing its annual additions to the reserve. (Roanoke Vending Exchange, Inc., supra; Black Motor Co., 41 B.T.A. 300, aff'd on other issues, 125 F. 2d 977.)

It is also clear that respondent's determinations with respect to the propriety of additions to bad debt reserves carry much weight because of the express statutory discretion given. Accordingly, the burden of proof on a taxpayer regarding such determinations is greater than the usual burden facing one who seeks to overcome the presumption of correctness which attaches to an ordinary notice of deficiency. (Roanoke Vending Exchange, Inc., supra.) The taxpayer must not only demonstrate that additions to the reserve were reasonable, but also establish that respondent's actions in disallowing those additions for the years in question were arbitrary, and amounted to an abuse of discretion. (Roanoke Vending Exchange, Inc., supra; see also S. W. Coe & Co. v. Dallman, 216 F. 2d 566; Maverick-Clarke Litho Co. v. Commissioner, 2d 587; Lancaster Stone Products Corp., supra; Appeal of Livingston Bros., Inc., Cal. St. Bd. of Equal., Oct. 16, 1957.) When we apply these principles, appellant simply has not met this burden.

It is true that a reserve method may be used basing additions upon 90 day or older accounts. (T. O. McCamant, 32 T. C. 824.) The critical flaw here, however, is that appellant's calculations resulted in excessive additions to the reserve and excessive bad debt deductions for the years in question.

Appellant's contention that bad debts should not be charged against the reserve is clearly erroneous because proper accounting procedure requires such charge-offs. (T. O. McCamant, supra.) It is evident that appellant's failure in this regard was a major factor in building an excessive reserve.

Appellant's other claims of error are also not supported. It is a proper procedure in using a test period not to include in the test accounts apparently worthless in the earlier part of the period that are recovered later in the period. (Black Motor Co., supra.) Moreover, appellant's allegations of respondent's understatement of accounts receivable and use of improper

bad debt amounts have not been substantiated.

.We do note that respondent's use of the years 1967 through 1970 as a test period to calculate the ratio of net bad debts to accounts receivable was unusual. Test periods for such a calculation found in the federal cases usually end with' the taxable year under consideration. (See Black Motor Co., supra; S. W. Coe & Co. v. Dallman, supra.) We'cannot say, however, that a test period using subsequent years is not meaningful. As -previously indicated, subsequent loss experience may properly be considered as additional evidence to demonstrate the unreasonableness of a taxpayer's method of computing his annual deduction.

In summary, appellant has not established that the additions to the reserve were reasonable and has not demonstrated that there was an abuse of discretion on the part of the respondent. Consequently, we must sustain respondent's action.

ORDER

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 Vaughn F. and Betty F. Fisher against proposed assessments of additional personal income tax in the amounts of $284.58 and $511.40 for the years 1967 and 1968, respectively, be and the same is hereby sustained.

John W. Lynch, Chairman

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_____, Member

_____, Member

_____. Member

ATTEST: _____, Secretary

Done at Sacramento, California, this 7th day of January, 1975, by the State Board of Equalization.