BEFORE TBE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 84R-603
LUNSFORD TOYOTA, INC.)

For Appellant: Ted Kobayashi
Certified Public Accountant

For Respondent: Mary Olden
Counsel

O P I N I O N

This appeal is made pursuant to section 26075, subdivision (a), 1/ of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claims of Lunsford Toyota, Inc. for refund of franchise tax in the amounts of $5,880.87 and $3,169.00 for the income years 1979 and 1980, respectively.

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

The issue presented for decision is whether respondent abused its discretion in recomputing a reasonable addition to appellant's bad debt reserve.

Appellant is a California corporation engaged in the retail sale of automobiles. It was incorporated in 1975 and is an accrual-basis taxpayer which has selected the reserve method of accounting for its bad debts. In addition to other bad debt losses, appellant incurs losses as a result of the repossession of cars it previously sold. When appellant sells an automobile financed by certain lending institutions, it remains a guarantor on the loans for the entire term of the loan. If a buyer defaults the automobile is repossessed, and appellant is liable for any loss suffered by the lending institution. Apparently, appellant accounts separately for these losses. For the income years 1979 and 1980, appellant made additions to its reserve account for repossession losses of $81,640 and $33,014, respectively. The current controversy concerns these additions.

Initially, respondent disallowed appellant's claimed additions for income years 1979 and 1980 on the ground that appellant failed to establish and maintain a suspense account as required by section 24348, subdivision (b)(4)(A). After the notices of proposed assessment reflecting this determination became final, appellant paid the tax in full and filed claims for refund. Respondent then determined that appellant had not violated the suspense account requirement. However, respondent determined that appellant's deductions for additions to its bad debt reserve were excessive and recomputed the additions using the formula derived from the decision in Black Motor Co. v. Commissioner, 41 B.T.A. 300 (1940), affd. on other grounds, 125 F.2d 977 (6th Cir. 1942). Respondent determined that appellant's proper addition for *income* year 1979 was $33,787 and that appellant was entitled to no addition for income year 1980. Therefore, it partially disallowed appellant's refund claim for income year 1979 and completely disallowed the claim for income year 1980. Appellant filed a timely appeal from these actions.

Section 24348 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 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. Appellant must do more than demonstrate that its additions to the reserve were reasonable; it must establish that respondent's determination. of the additions was so unreasonable and arbitrary as to constitute an abuse of discretion. (Roanoke Vending Exchange, Inc. v. Commissioner, 40 T.C. 735 (1963); Appeal of Vaughn F. and Betty F. Fisher, Cal. St. Bd. of Equal., Jan. 7, 1975.)

The Black Motor bad debt formula utilized by respondent was approved by the United States Supreme Court in Thor Power Tool Co. v. Commissioner, 439 U.S. 522 [58 L.Ed.2d 785] (1979), and by this board in Appeal of Brighton Sand and Gravel Company, decided August 19, 1981. Since it is settled that the Black Motor formula is valid, the only question is whether respondent.abused its discretion by using the formula in this case. If a taxpayer's recent bad'debt experience is unrepresentative, or if the taxpayer can point to conditions that will cause future debt collections to be less likely than in the past, the taxpayer is entitled to an addition larger than the Black Motor formula would provide. (Thor Power Tool Co. v. Commissioner, supra.)

Appellant contends that respondent's use of the Black Motor formula was inappropriate and amounted to an abuse of discretion because it ignored certain changes in the automobile industry. These changes included the lengthening of the financing period from three to five years and the general slump in the industry. While changed business conditions can cause the Black Motor formula to be inapplicable (see Richardson v. United States, 330 F.Supp. 102 (S.D. Texas 1971)), the taxpayer must establish that the changed conditions caused collection of its outstanding debts to be less likely than in the past. (Thor Power Tool Co. v. Commissioner, supra; Valmont Industries, Inc. v. Commisioner, 73 T.C. 1059 (1980).) Appellant has offered no evidence to establish that its outstanding debts during the appeal years were less likely to be collected than were its debts in the past. Mere generalizations regarding business conditions do not meet the taxpayer's burden of proof. (Fairmont Homes, Inc. v. Commissioner, ¶ 83,209 T.C.M. (P-H) (1983).) Appellant also contends that its accounts

receivable increased dramatically in 1979. This factor would not cause the Black Motor formula to be inappropriate, however, since that formula is directly responsive to changes in volume. (Valmont Industries, Inc. v. Commissioner, supra.)

Finally, appellant contends that a larger reserve than allowed by respondent was necessary, since the financing institutions required appellant to maintain reserves equal to more than one year's anticipated losses. Although this may have been a sound business practice, it does not follow that the reserve established under section 24348 should be in the same amount. (S. W. Coe & Co. v. Dallman, 216 F.2d 566 (7th Cir. 1954); Valmont Industries, Inc. v. Commissioner, supra.)

For the foregoing reasons, we find that appellant has failed to meet its burden of proving that respondent abused its discretion in recomputing a reasonable addition to appellant's bad debt reserve. Therefore, respondent's action must be sustained.

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 26077 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claims of Lunsford Toyota, Inc., for refund of franchise tax in the amounts of **$5,880.87** and **$3,169.00** for the years 1979 and 1980, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 6th day Of November, 1985, by the State Board of Equalization, with Board Members Mr. Dronenburg, Mr. Collis, Mr. Bennett and Mr. Harvey present.

Ernest J. Cronenburg, Jr., Chairman

Conway H. Collis, Member

William M. Bennett, Member

Walter Harvey*, Member

_____, Member

*For Kenneth Cory, per Government Code section 7.9