BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 84A-1373-KP
DESIGN MART, INC.)

For Appellant: Roy A. Steiner
Certified Public Accountant

For Respondent: Patricia I. Hart
Counsel

O P I N I O N

This appeal is made pursuant to section 25666 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Design Mart, Inc., against a proposed assessment of additional franchise tax in the amount of $1,402 for the income year 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 on appeal is whether respondent abused its statutory discretion in disallowing appellant's addition to its bad debt reserve for the income year in question.

Appellant is a California corporation engaged in the wholesale furniture, business. Appellant maintains its books on the accrual method of accounting and utilizes a reserve account for bad debts. For the income year at issue, appellant used a set formula to determine its bad debt reserve level. The formula increased or decreased the reserve by an amount equal to the total of all accounts receivable which were 90 days or more overdue as of the end of appellant's income year, December 31. For the income year ended December 31, 1981, appellant added $14,606 to its reserve to bring the account balance to $27,549. For that same year, appellant charged off $1,835 against the reserve.

Appellant's tax return for the income year 1981 was reviewed by respondent. Upon applying the six-year moving average formula set forth in Black Motor Co. v. Commissioner, 41 B.T.A. 300 (1940), respondent determined that appellant's stated reserve for 1981 was much higher than the formula allowed. Respondent determined that the reserve level should have been $3,714.58 rather than the $27,549 claimed by appellant. Accordingly, respondent denied the addition to the reserve in its entirety. An assessment was issued and appellant protested. The protest was denied and this appeal followed.

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

Respondent's authority to oversee appellant's use of the reserve method of accounting for bad debts comes from section 24348, subdivision (a), which provides, in pertinent part, that "[t]here 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." Section 24348 is based on and is substantially similar to Internal Revenue Code section 166. Consequently, the determinations of federal courts construing the federal statute are entitled to great weight in interpreting section 24348. (Meanley v. McColgan, 49 Cal.App.2d 203 [121 P.2d 45] (1942).)

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. 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 those additions were arbitrary and amounted to an abuse of discretion. (Appeal of H-B Investments, Inc., Cal. St,. Bd. of Equal., June 29, 1982; Appeal of Brighton Sand and Gravel Company, Cal. St. Bd. of Equal., Aug. 19, 1981.)

The reasonableness of an addition will depend primarily upon the total amount of debts outstanding as of the close of the income year, including those arising currently as well as those arising in prior years, and the total amount of the existing reserve. (Treas. Reg. § 1.166-4(b)(1).) "In addition . . . the past experience of the taxpayer in collecting accounts and notes receivable is a reliable guide for measuring probable future losses." (Roanoke Vending Exchange, Inc. v. Commissioner, supra, 40 T.C. at 741.)

Appellant argues that respondent's use of the Black Motor formula does not take into account the nature of appellant's business and the changed business climate of the furniture industry during the early 1980's. Although disregard of a taxpayer's business circumstances can constitute abuse of discretion on the part of respondent (Richardson v. United States, 330 F.Supp. 102 (S.D. Tex. 1971)), appellant must demonstrate that changed circumstances in 1981 caused its reserve to be inadequate. (Thor Power Tool, Co. v. Commissioner, 439 U.S. 522 [58 L.Ed.2d 785] (1979).) A taxpayer must be able to point

to specific conditions that would cause future debt collections to be less likely to occur than in the past. (Thor Power Tool Co. v. Commissioner, supra.) While specific information that the collection of certain accounts is doubtful may justify a larger reserve requirement than the Black Motor-formula would allow (Appeal of Pringle Tractor Co., Cal. St. Bd. of Equal., Mar. 7, 1967), the mere aging of accounts is not, by itself, enough to overcome respondent's determination. (Thor Power Tool Co. v. Commissioner, supra; United States v. Haskel Engineering & Supply Co., 380 F.2d 786 (9th Cir. 1967); Rev. Rul. 76-362, 1976-2 C.B. 45.)

An unsupported statement by appellant that the nature of its business requires a larger reserve than its past history indicates does not satisfy its burden of proving its proposed addition is reasonable. (Appeal of Air Conditioning Sales, Inc., Cal. St. Bd. of Equal., Oct. 9, 1985.) Appellant has not provided us with any evidence that would indicate that it had information in 1981 that any of its delinquent accounts receivable would become uncollectable in 1982, thereby justifying such a sharp increase in its reserve. Rather, appellant has simply provided us with information that indicates that some of the accounts may not have been collectable in the years following 1981. We note that even if some of the accounts did become worthless subsequent to the year at issue, that fact alone is no support for appellant's 1981 addition. (Calavo, Inc. v. Commissioner, 304 F.2d 650 (9th Cir. 1962).)

Finally, the fact that appellant had used a mechanical formula based upon a percentage of its delinquent accounts receivable to determine its reserve level for a number of years does not, in and of itself, justify a particular reserve level or the continued use of the formula. (Roanoke Vending Machine v. Commissioner, supra.) In Appeal of Air Conditioning Sales, Inc., supra, this board discussed the use of such a percentage formula and determined that the consistent adherence to such a formula does not automatically create a finding that the addition is reasonable. The ultimate question is not whether the use of a formula is proper, but whether the balance in the reserve at the end of the year is adequate to cover the expected worthlessness of the outstanding debts. (Appeal of Air Conditioning Sales, Inc., supra.) Consequently, a formula, like the one used by appellant, will only produce a satisfactory result where a relative consistency has emerged in the pattern of the taxpayer's bad debt losses and there is a

correlation between those losses and the balance in the reserve. (Appeal of Air Conditioning Sales, Inc., supra.) In the present case, the formula used by appellant bloated its reserve far beyond what appellant's history of bad debt write-offs justified. Accordingly, strict adherence to the formula during the year at issue was not justified.

We reiterate that it is appellant's "heavy burden" to show that respondent's determination is unreasonable and that its own addition is reasonable. By failing to show that its reserve balance at the end of the income year 1981, prior to any addition, was inadequate to absorb those debts reasonably expect to become uncollectable in the income year 1982, appellant has not carried its burden. Accordingly, respondent's action in this matter must be sustained.

Appeal of Design Mart, 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 therefot,

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 Design Mart, Inc., against a proposed assessment of additional franchise tax in the amount of $1,402 for the income year 1981, be and the same is hereby sustained.

Done at Sacramento, California, this 9th day Of April , 1986, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Collis, Mr. Bennett and Mr. Harvey present.

Richard Nevins, Chairman

Conway H. Collis, Member

William M. Bennett, Member

Walter Harvey*, Member

, Member

*For Kenneth Cory, per Government Code section 7.9