BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 82A-232-PD
TIMES FURNITURE COMPANY)

For Appellant: Charles H. Rosenblatt
Certified Public Accountant

For Respondent: Lazaro L. Bobiles
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 Times Furniture Company against a proposed assessment of additional franchise tax in the amount of $2,361 for the income year ended June 30, 1977.

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.

Appeal of Times Furniture Company

The issue in this appeal is whether appellant is entitled to the losses it claimed on the repossession of furniture sold on account.

Appellant operates a retail furniture store and employs the accrual method of accounting. Although appellant maintained a bad debt reserve, it apparently took a separate deduction on its return for "repossession losses", which related to furniture appellant sold at retail and later repossessed. The claimed losses were computed by reducing the unpaid account balances by the unused carrying charges and the wholesale value of the repossessed furniture, as estimated by appellant. For the income year ended June 30, 1977, respondent disallowed the $23,112 deduction claimed as a repossession loss, on the ground that the unpaid accounts (less the unearned carrying charges) should have been charged against appellant's bad debt reserve and the fair market value of the repossessed furniture should have been added to the bad debt reserve.

In this appeal, appellant contends that its claimed repossession loss deduction was proper. Appellant also maintains that if the repossession loss was required to be charged against its bad debt reserve, it is entitled to a corresponding $23,112 increase in the amount of the deductible addition to its bad debt reserve. Finally, appellant argues that respondent's requirement that its repossessionlosses be charged against its bad debt reserve constituted an involuntary change in accounting method which required the application of the mitigating provisions of sections 24721-24723.

Section 24348 of the Revenue and Taxation Code 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.

Similar provisions are contained in the federal law. (I.R.C., § 166.)

Under the reserve method for handling bad debts, the reserve is increased by crediting it with reasonable additions. Those addition's to the reserve are allowed as deductions on that taxpayer's return. The reserve is decreased by charging it with specific bad

debts which become worthless. Those bad debts are not deductible on that taxpayer's return.

Bad debt reserve accounts are intended to handle normal losses that arise in the ordinary course of a taxpayer's day-to-day operations. Losses which are rare or unpredictable in nature and amount should be handled apart from the taxpayer's bad debt reserve. (Rev. Rul. 74-409, 1974-2 C.B. 61; cf. Appeal of Brighton Sand and Gravel Company, Cal. St. Bd. of Equal., Aug. 19, 1981.) The accounts in question in this appeal are those involved in the normal day-to-day retail sales of furniture by appellant and would not be considered rare or unpredictable in nature. Accordingly, those accounts which go bad are properly handled by appellant's bad debt reserve and are not separately deductible on appellant's return. Therefore, respondent properly denied the claimed bad debt deduction.

We next turn to appellant's contention that if $23,112 is not allowed as a bad debt deduction, then the deduction allowed for an addition to its bad debt reserve must be increased by $23,112. Respondent's determination with respect to proper additions to a reserve for bad debts carries great weight because of the express discretion granted respondent by section 24348. In this case, respondent has determined that the addition appellant made to its bad debt reserve for the income year in question was sufficient and need not be increased to make a specific allowance for the disallowed "repossession loss" bad debt deduction. To overcome that determination, appellant must not only demonstrate that the increased addition to its bad debt reserve which it now proposes is reasonable, but also must establish that respondent's action in opposing an increase in its bad debt deduction is arbitrary and amounts to an abuse of discretion. (Appeal of Brighton Sand and Gravel Company, supra; Appeal of Vaughn F. and Betty F. Fisher, Cal, St. Bd. of Equal., Jan. 7, 1975.)

The most widely applied formula for determining proper additions to bad debt reserves is set forth in Black Motor Co. v. Commissioner, 41 B.T.A. 300 (1940), affd. on other issues, 125 F.2d 977 (6th Cir. 1942), approved by the U.S. Supreme Court in Thor Power Tool Co. v. Commissioner, 439 U.S. 522 [58 L.Ed.2d 7851 (1979). That formula applies a taxpayer's own experience with losses in prior years and establishes a percentage level for the reserve in determining the need and amount of a current addition.

The bad debt reserve schedule reported on appellant's return for the income year ending June 30, 1977, indicates that the six-year average ratio of appellant's net bad debts (amounts charged against the reserve less the recoveries added to the reserve) compared to appellant's trade notes and accounts receivable outstanding at the end of the year was **9.51** percent. The amount of appellant's trade notes and accounts receivable outstanding at the end of the last year so reported was **$1,170,727;** 9.51 percent of that amount would be $111,336, which would be the expected amount of the next year's net bad debts if the next year maintained exactly the same ratio as the overall **preceeding** six-year period. For that last year, appellant provided for a $139,160 addition to its bad debt reserve. That addition plus $20,270 in recoveries on its bad debts less $150,251 in bad accounts charged off against the bad debt reserve **left** a $320,140 bad debt reserve at the end of the last scheduled year. The amount of the $320,140 bad debt reserve appears sufficient when compared to the $111,336 in estimated net bad debts expected for the succeeding year. If that $320,140 appears sufficient, then the $139,160 addition to the reserve, which was originally computed by appellant and approved by respondent, appears to be sufficient also. Accordingly, appellant has failed to demonstrate that failure to increase the $139,160 addition by $23,112 was an abuse of discretion by respondent.

Finally, respondent's requirement that appellant's bad debts on retail sales of furniture be charged against its bad debt reserve and not be directly deducted as business losses on its return does not constitute a change in accounting method. Respondent is simply requiring that appellant's accounting handle its ordinary bad debts in the manner required by a bad debt reserve method.

For the reasons stated, we must sustain respondent's action.

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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 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Times Furniture Company against a proposed assessment of additional franchise tax in the amount of $2,361 for the income year ended June 30, 1977, be and the same is hereby sustained.

Done at Sacramento, California, this 10th day of June, 1986, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Collis, Mr. Bennett, Mr. Dronenburg and Mr. Harvey present.

Richard Nevins, Chairman

Conway H. Collis, Member

William M. Bennett, Member

Ernest J. Dronenburg, Jr., Member

Walter Harvey*, Member

*For Kenneth Cory, per Government Code section 7.9