



87-SBE-057

BEFORE THE STATE BOARD **OF** EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
METALMART, **INC.**) No. **82A-1983-SW**

For Appellant: Aloke Bosu
Certified Public Accountant

For Respondent: Donald C. McKenzie
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 Metalmart, Inc., against a proposed assessment of additional franchise tax in the amount of \$6,245 for the income year ended June 30, **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.

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The sole issue presented in this appeal is whether respondent abused its statutory discretion by reducing the claimed additions to appellant's bad debt reserve for the year in question.

Appellant is a California corporation which employs the accrual method of accounting and which on its franchise **tax returns** uses the reserve method of accounting for its bad debts. In the income year ended June 30, 1981, appellant deducted \$80,660 as an addition to its bad debt reserve and charged off \$67,660 against the reserve. This latter figure was allegedly based upon appellant's determination that two accounts, Pacific Aerospace and Chugiak Boat Works, became worthless during that year. Respondent found the addition to be unreasonable and, **using** a six-year moving average formula as defined in Black Motor Co. v. Commissioner, 41 B.T.A. 300 (1940), affd., 125 F.2d 977 (6th Cir. 1942), determined that appellant's six-year bad debt percentage was 3.127 percent and that its bad debt reserve balance should be \$46,954 rather than the \$112,000 reported on its return. Appellant contends that it has met its burden of showing that the addition to its reserve is reasonable and that respondent abused its discretion in denying the addition.

Subdivision (a) of section 24348 provides:
"(a) **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." This language is substantially the same as that of Internal Revenue Code section 166(c). Consequently, federal precedent is persuasive in interpreting section 24348. (Meanley v. McColgan, 49 Cal.App.2d 203, 209 [121 P.2d 45] (1942).)

As we have noted in previous opinions, respondent's determinations with respect to additions to a **reserve** for bad debts carry great weight because of the **express** discretion granted it by statute. When the Franchise Tax Board disallows an addition to a reserve for bad debts, the taxpayer must not only demonstrate that 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. (Roanoke Vending Exchange, Inc. v. Commissioner, 40 T.C. 735 (1963)). In other words, by **choosing** to use the reserve method, appellant has **subjected** itself to the reasonable discretion of respondent.

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(Union National Bank & Trust Co.' of Elgin v. Commissioner, 26 T.C. 537 (1956).)

A bad debt reserve is essentially an estimate of future losses which can reasonably be expected to result from debts outstanding at the close of the taxable year. (Valmont Industries, Inc. v. Commissioner, 73 T.C. 1059 (1980).) Under the reserve method of handling bad debts, the reserve is reduced by charging against it specific bad debts which become worthless during the income year and is increased by crediting it with reasonable additions. What is reasonable will depend on the total amount of debts outstanding at the end of the year, including current debts, as well as those of prior years, and the total amount of the existing reserve.

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 contends that because of collection problems with two accounts, additions to its reserve are necessary. We cannot agree. As to the debt with Chugiak Boat Works, the business was still operating and paying some of its debts as late as 1982. We cannot conclude that this debt was worthless as of June 30, 1981. Likewise, as to the debt owed by Pacific Aerospace, payments were made on that account as late as October of 1981, and appellant still had materials owned by Pacific Aerospace which were valued at \$61,000 and which could have been sold to reduce the debt owed. Appellant has presented no evidence which would indicate that the recovery of these accounts was so uncertain at the end of June in 1981, that respondent's disallowance of an addition to the reserve to cover these debts amounted to an abuse of discretion. We must conclude, therefore, that appellant has not carried its burden of proof. Respondent's action must be sustained.

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O R D E R 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 Metalmart, Inc., against a proposed assessment of additional franchise tax in the amount of \$6,245 for the income year **ended** June 30, 1981, be and the same is hereby sustained.

Done at Sacramento, California, this 28th day
Of **July**, 1987, by the State Board of Equalization,
with **Board** Members Mr. **Collis**, Mr. Bennett, Mr. Carpenter
and Ms. Baker present.

Conway H. Collis	, Chairman
William M. Bennett	, Member
Paul Carpenter	, Member
Anne Baker*	, Member
	, Member

*For Gray Davis, per Government Code section 7.9