



Appeal of Temple Hospital Corporation

The issue presented by this appeal is whether appellant has shown that respondent's modification and disallowances of the claimed additions to appellant's bad debt reserve for the income years in question constituted an abuse of discretion.

Appellant was incorporated in 1962 to operate a hospital facility on a profit-making basis. Appellant is an accrual basis taxpayer that employs the reserve method of accounting for bad debts. In 1978, appellant was sold to a new management group that determined that many of appellant's accounts receivables were uncollectable. In anticipation of writing off those bad debts, appellant's new managers proceeded to substantially increase its bad debt reserve over the following income years. On its franchise tax returns for the income years at issue, appellant claimed deductions of \$431,182, \$163,941, and \$201,734, for additions to its bad debt reserve for the income years ended May 31, 1980, May 31, 1981, and **May 31, 1982**, respectively.

Respondent reviewed the returns in question and determined that appellant had not shown its need for the higher reserve. The Franchise Tax Board **used the six-** year moving average formula approved in Black Motor Co. v. Commissioner, 41 B.T.A. 300 (1940), affd., 125 **F.2d 977** (6th Cir. 1942), to recompute appellant's bad debt reserve additions for those years. Respondent determined that a reasonable addition for the income year 1980 was \$294,285. For the years 1981 and 1982, respondent determined that no additions were necessary. Proposed assessments based on respondent's recomputations **were** issued. Appellant protested, arguing that changed business circumstances supported their claimed additions. After considering the protest, **respondent** affirmed its original assessments and this appeal followed.

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, 209 [121 **p.2d** 45] (1942).)

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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. 519 (1963)) The ultimate **question** in determining the **reasonableness** of an addition is whether the total balance in the reserve at year's end is adequate to cover the expected future losses from existing bad debts, not whether the proposed addition is sufficient for that purpose. (Black Motor Co. v. Commissioner, supra; Appeal of John Manning & Company, Inc.; Cal. St. Bd. of Equal., Dec. 3, 1985.) If, at the **current** year's end, the reserve **balance** is sufficient to absorb the bad debt losses 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.)

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 & 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 ordinary presumption of correctness which attaches to a 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 these additions were arbitrary and amounted to an abuse of discretion. (Appeal of H-B Investment, Inc., Cal. St. Bd. of Equal., June 29, 1982; Appeal of Brighton Sand and Gravel Company, Cal. St. Bd. of Equal., Aug. 19, 1981.) 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 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, 439 U.S. 522 [58 L.Ed.2d 785] (1979).)

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Appellant argues that respondent's use of the Black Motor formula does not **take into** account the change in appellant's business as evidenced by the change in management. Appellant points out that its new management decided that many of its accounts receivable should be written off, even though many of the accounts were still active, with debtors making partial payments. In anticipation of the increased charges against the reserve, appellant substantially increased its reserve. It is appellant's position that a decision by its management to write off these debts should be sufficient to justify its reserve increases.

Even if we were to agree that a management decision to write off a large portion of its accounts receivable as uncollectable was not reviewable, the taxpayer must still demonstrate that its unadjusted reserve was inadequately funded. (See Thor Power Tool Co. v. Commissioner, supra.) At the beginning of its 1980 **income** year, appellant's reserve stood at \$477,000. At the end of **income** year 1982, after all of the bad debts had **been** deducted against the reserve and prior to any addition for 1983, the reserve stood at \$801,397. Furthermore, while it is true that appellant's rate of charge-offs did increase over 1980 and 1981, the rate never exceeded seven percent of its outstanding receivables, and the rate of charge-offs in 1982 actually diminished to its 1977 level. Even after respondent's adjustments, appellant's reserve was adequate to absorb those bad debts reasonably expected to be uncollectable during each respective year at issue. Clearly, appellant's deductions overfunded its reserve for the years at issue.

Appellant's argument that it needed a larger reserve because it planned to charge off more bad debts in the future is **no** justification for the large increases during the appeal years. (Calavo, Inc. v. Commissioner, 304 F.2d 650 (9th Cir. 1962).) As stated in Roanoke Vending Exchange, Inc. v. Commissioner, supra, 40 T.C. at 741, "reliance may not be placed upon subsequent events to justify enlarging the estimate of an already **reasonable** reserve."

Appellant **attempts to** bolster its argument by contending that a large reserve was necessary in light of the increase in its accounts receivable. Although disregard of a taxpayer's changed business circumstances can constitute abuse of discretion on the part of respondent (Richardson v. United States, 330 F.Supp. 102 (S.D.

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**Tex. 1971**)), appellant has failed to demonstrate that changed circumstances in 1979 caused appellant's **reserve** to be inadequate. (Thor Power Tool Co. v. Commissioner, supra.) Whether or not an increase in sales and accounts receivable inevitably results in a higher rate of default is not the question. **As** stated by the court in **Fort Howard Paper Company v. Commissioner**, ¶ 77,422 T.C.M. (P-H) (1977):

The petitioner's position is that it should be allowed to increase the balance in its reserve for bad debts . . . , because it enjoyed increases in its net sales and accounts receivable during those years. However, the petitioner has failed to demonstrate that its existing reserve balance was not adequate to offset losses reasonably to be anticipated from such increased sales. Indeed, in the past, its reserve for bad debts has substantially exceeded actual losses sustained. Thus, the petitioner has completely failed to show that a reserve . . . , as permitted by the Commissioner . . . , was not sufficient to offset anticipated losses; accordingly, we hold that the petitioner has failed to prove that the Commissioner abused his discretion in disallowing deductions for additions to the reserve **[for the years at issue]** ....  
(Emphasis added.)

Finally, appellant argues in the alternative that it should be allowed to deduct **the** uncollectable debts it carried on its books during the years at issue directly from income as extraordinary losses. (See Rev. Rul. 74-409, 1974-2 C.B. 61 (1974).) Appellant, however, has failed to prove, or even fully argue, its claim to any extraordinary losses.

We reiterate that it is appellant's "heavy burden" to show that respondent's determination is unreasonable and that its own additions are reasonable. By failing to show that its reserve balance at the end any of the income years in question, prior to any addition, was inadequate to absorb those debts reasonably expected to become uncollectable during the respective income year, appellant has not carried its burden. (Appeal-of Air Conditioning Sales, Inc., supra.)

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Accordingly, respondent's action in this matter must be sustained.

