

STATE OF ALABAMA,
DEPARTMENT OF REVENUE,

vs.

HUEY L. AND EDNA M. BRANNON
3401 Azalea Lane
Tuscaloosa, AL 35405,

Taxpayers.

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STATE OF ALABAMA
DEPARTMENT OF REVENUE
ADMINISTRATIVE LAW DIVISION

DOCKET NO. INC. 92-100

FINAL ORDER

The Revenue Department partially denied a refund of 1989 income tax claimed by Huey L. and Edna M. Brannon (Taxpayers). The Taxpayers appealed to the Administrative Law Division and a hearing was conducted on September 8, 1992. Huey Brannon (Taxpayer) appeared at the hearing. Assistant counsel Mark Griffin represented the Department.

FINDINGS OF FACT

The Department audited the Taxpayers and initially assessed additional income tax due for 1986, 1987 and 1989. The Department subsequently voided the assessments and accepted the Taxpayers' returns as filed, except a 1987 net operating loss (NOL) carryover from 1987 to 1989 was disallowed.

The Department concedes that the Taxpayers suffered a loss in 1987. The issue in dispute is whether the loss was incurred in the Taxpayer's regular trade or business. If so, then the loss can be recognized in full in computing the allowable NOL carryover to 1989 and the disputed refund should be allowed. If the loss was not

attributable to the Taxpayer's trade or business (nonbusiness), then it can be recognized for NOL purposes only up to the amount of the Taxpayer's nonbusiness income in 1987. See, Code of Ala. 1975, §40-18-15(a)(16)f.3. In that case, the carryover should be disallowed. The relevant facts are set out below.

The Taxpayer made 18 loans from October 1984 through June 1986 to four different corporations totalling \$683,501. The Taxpayer loaned the money to get the corporations started in the mobile home business. All four corporations were owned by individuals that the Taxpayer had known and trusted for several years, including his own son.

The Taxpayer borrowed most of the money used to make the loans. The Taxpayer intended to profit on the spread between the interest he paid on the borrowed money (approximately 7.5% to 10%) and the interest he charged to the corporations (12%).

The loans were payable on demand and were at 8% interest. However, no periodic interest payments were required or made. The loans were unsecured except in some cases shares in the corporations were pledged by the individuals. The Taxpayer testified that he trusted the individuals that operated the corporations to become successful and eventually repay the loans plus interest.

All four corporations failed in 1987 and the Taxpayers claimed the unpaid loan amounts as a bad debt deduction on their 1987 Alabama return.

The Department concedes that the loans were transactions entered into for profit and thus deductible by the Taxpayers in 1987 pursuant to Code of Ala. 1975, §40-18-15(a)(5). However, the Department argues that the losses were nonbusiness losses for NOL purposes because the Taxpayer was not in the regular trade or business of making loans.

CONCLUSIONS OF LAW

All deductions not attributable to a taxpayer's trade or business can be recognized for NOL purposes only up to the amount of the taxpayer's income not derived from such trade or business.

See, §40-18-15(a)(16)f.3. The question in this case is whether the Taxpayer was in the regular trade or business of making loans.

Whether a taxpayer is engaged in a trade or business for tax purposes must be decided on a case by case basis. Fischer v. U.S., 336 F.2d 428. The intent to make a profit is essential, but that alone is not enough. The taxpayer must also be regularly and actively engaged in the activity over an extended period, Staunton v. Commissioner, 399 F.2d 326, the taxpayer must hold himself out to the public as offering goods and services in the regular course of business, Gajewski v. C.I.R., 723 F.2d 1062, and the taxpayer must conduct business in a responsible, business-like manner,

Schley v. C.I.R., 375 F.2d 747. See also Zell v. C.I.R., 763 F.2d 1139.

The Taxpayer in this case was not regularly engaged in making loans for profit and did not hold himself out to the public as being in the business of making loans. The Taxpayer also did not treat the loans in a responsible, business-like manner. A responsible businessman would have required some collateral for the loans. Also, the loans would have had a fixed due date and would have required periodic interest payments. Assuming an average 3% spread on the loans, the Taxpayer could have expected a profit of approximately \$20,000 per year, assuming that periodic interest had been paid. A prudent businessman would not risk almost \$700,000 in unsecured money with the hope of making at most only a \$20,000 per year profit. The Taxpayer also had to pay interest on the money he borrowed, while at the same time the corporations were not required to make any periodic interest payments to the Taxpayer.

The burden is on the Taxpayer to prove that he was in the trade or business of making loans. The Taxpayer has failed to do so in this case. Consequently, the loans were nonbusiness transactions and the 1989 refund was properly disallowed by the Department.

This Final Order may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, §40-2A-9(g).

Entered on October 22, 1992.

BILL THOMPSON
Chief Administrative Law Judge