JOSEPH F., JR. & SHARON SCHNEIDER 5 Old Chimney Road SE Huntsville, Alabama 35801,	'	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayers,	'	DOCKET NO. INC. 97-334
v.	'	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	'	

FINAL ORDER

The Revenue Department assessed 1994 income tax against Joseph F., Jr. and Sharon H. Schneider (together ATaxpayers@). The Taxpayers appealed to the Administrative Law Division pursuant to Code of Ala. 1975, '40-2A-7(b)(5)a. A hearing was conducted on January 21, 1998. Dana Gibson represented the Taxpayers. James Brabston and Christine Sampson Hinson filed a post-hearing brief for the Taxpayers. Assistant Counsel Jeff Patterson represented the Department.

The issue in this case is whether the Taxpayers should be allowed to deduct a loss on their 1994 Alabama return. That issue involves three sub-issues:

(1) Did the Taxpayers sustain a loss in 1994;

(2) If the Taxpayers sustained a loss in 1994, was the loss incurred in a trade or business, and thus deductible pursuant to Code of Ala. 1975, '40-18-15(7); and

(3) If the loss was not incurred in a trade or business, was it incurred in a transaction entered into for profit, and thus deductible pursuant to Code of Ala. 1975, '40-18-15(5).

Joseph F. Schneider, Jr. (individually ATaxpayer@) is a radiation oncologist in

Huntsville, Alabama. The Taxpayer was employed by North Alabama Oncology, P.C. during the subject period. The Taxpayer was also a 50% shareholder in ICC of Huntsville, Inc. (AICCH@), a radiation cancer treatment facility affiliated with Columbia HCA Medical Center Hospital of Huntsville (AMedical Center Hospital@). The Taxpayer=s employer, North Alabama Oncology, had usage privileges at the Medical Center Hospital during the subject period.

The Taxpayer loaned ICCH $116,887.64 on December 31, 1993, and $40,129.19 on February 28, 1994. The loans were evidenced by promissory notes from ICCH to the Taxpayer, payable on demand and bearing 6% annual interest.

The Taxpayers argue that shortly after the second promissory note was executed, Huntsville Hospital announced it would purchase the Medical Center Hospital from Columbia HCA. The Taxpayers claim that the purchase eliminated the need for ICCH because Huntsville Hospital already had an adequate radiation cancer treatment facility. The Taxpayers contend that because of ICCH=s poor financial condition in April 1994, it was obvious that the Taxpayer=s loans to ICCH could not be repaid, and thus became worthless in 1994.

The Taxpayer sold his stock in ICCH to ICCA Investments, Inc. (AICCA@) pursuant to a stock purchase agreement on December 1, 1994. The Taxpayer received ten cents a share for his 250 shares, or $25.00. Pursuant to a second agreement also executed on December 1, 1994 by the same parties, the Taxpayer agreed to cancel the two promissory notes issued to him by ICCH. In return, ICCA agreed, subject to certain loss recoupment

provisions, to pay the Taxpayer 25% of the net profits from ICCA=s future operation of the cancer treatment center previously operated by ICCH, and 25% of the net profits from the sale of the assets of that cancer treatment center, up to $184,110, or until December 31, 2000, whichever occurs first. There is no evidence whether the Taxpayer has received any payments pursuant to the above agreement.

The Taxpayers claimed the two canceled promissory notes as a loss of $157,016.81 on their 1994 Alabama return. The Department denied the deduction, and based thereon entered the final assessment in issue. The Taxpayers appealed.

ISSUE (1) -- DID THE TAXPAYERS SUFFER A LOSS IN 1994?

For a loss to be deductible in a year, either as a business loss or as a loss in a transaction entered into for profit, the loss must be fixed by some closed and completed event or transaction in the year. Williams v. C.I.R., 584 F.2d 90 (1978); IRC Reg. 1.165-1(d)(1); Dept. Reg. 810-3-15-.07(2)(a). If and when a debt becomes worthless depends on the financial condition of the debtor and the circumstances relating to the debt. Levin v. U.S., 597 F.2d 760, 768 (1979); See also, 26 C.F.R. '1.166-2.

The Taxpayers claim that the two promissory notes became worthless in 1994 because ICCH was insolvent in April 1994. There is no evidence, however, that ICCH was solvent at the beginning of 1994. For a debt to become worthless during a year, the taxpayer must prove that the debt had some value at the beginning of the year. Levin v. U.S., 597 F.2d at 768. In any case, this appeal does not turn on whether ICCH became insolvent in 1994.

The Taxpayer canceled the two notes from ICCH. In return, the Taxpayer received the right to 25% of the future net profits from the operation of the old ICCH cancer treatment facility, or from the sale of the assets of that facility, up to $184,110. The notes thus did not become worthless in 1994. Rather, the Taxpayer exchanged the notes for the right to receive a percentage of the future profits from the operation and sale of the old ICCH facility. Because the Taxpayer=s investment in the notes did not become worthless in 1994, the Taxpayer did not sustain a loss in that year. The deduction was properly disallowed by the Department.

Disallowing the loss in 1994 raises the question of how any payments received by the Taxpayer pursuant to the November 1994 agreement should be taxed. Any amounts received in a year up to the annual interest that would have accrued under the promissory notes would constitute gross income to the Taxpayer. Any amounts received in a year over the accrued annual interest would reduce the Taxpayer=s basis, and would not constitute gross income to the Taxpayer. If and when the Taxpayer=s basis reached zero, any additional amounts would constitute gross income. If during any year certain identifiable events occurred that would make the Taxpayer=s right to receive income under the agreement worthless, the Taxpayer could claim a loss in that year for his remaining basis.

Issues (2) and (3) are pretermitted by the above holding. However, I will briefly address those issues for the benefit of the parties.

Assuming that a loss was sustained in 1994, it was not incurred in the Taxpayer=s

trade or business because the Taxpayer was not an employee of ICCH. Concerning whether the loan constituted a transaction entered into for profit, I agree with the Department that the Taxpayers failed to provide evidence as to the Taxpayer=s state of mind or intent in making the loans. I assume, however, that the Taxpayer made the loans to maintain or enlarge his oncologist practice at the Medical Center Hospital. Consequently, if a loss had been sustained in 1994, and if the Taxpayer had offered proof that he made the loans to benefit his oncology business, the loss could have been deducted in 1994.

The final assessment includes a penalty, which can be waived for reasonable cause. Code of Ala. 1975, '40-2A-11(h). I find reasonable cause to waive the penalty in this case.

The final assessment, less the penalty, is affirmed. Judgment is entered against the Taxpayers for 1994 income tax and interest of $4,358.32, plus applicable additional interest.

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

Entered November 18, 1998.

BILL THOMPSON
Chief Administrative Law Judge

BT:ks

cc: Jeff Patterson, Esq.
Dana Gibson, Esq.
James Brabston, Esq.
Christine Hinson, Esq.
Kim Herman (202-32-0949)