JOSEPH H., SR. & EVELYN C. BRADY 4260 Old Leeds Road Birmingham, AL 35213-3212,	§	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayers,	§	DOCKET NO. INC. 97-426
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

FINAL ORDER

The Revenue Department assessed 1993 and 1994 income tax against Evelyn C. and Joseph H. Brady (together "Taxpayers"). 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 February 24, 1998. David Cork and Craig Waide represented the Taxpayers. Assistant Counsel Dan Schmaeling represented the Department.

This case involves the net operating loss ("NOL") deduction at Code of Ala. 1975, §40-18-15(16). The primary issue is whether the Taxpayers can carry over a 1990 loss as an NOL to 1993 and 1994. That issue turns on whether the loss was a "business" or "non-business" loss. Only business-related losses incurred in a taxpayer's trade or business may be used in computing an NOL carryover. §40-18-15(16)f.3. A second issue is whether the penalties assessed by the Department should be waived.

Joseph Brady (individually "Taxpayer") owned and was an employee of Joseph H. Brady and Associates, Inc. ("corporation"). The corporation operated a lawn and garden equipment business based in Birmingham. The corporation began borrowing money in the late 1970s or early 1980s, primarily to purchase two farm equipment dealerships in Florida, and also an equipment manufacturing business in Alabama. The lenders required the Taxpayer to personally guarantee the loans by pledging stock.

The corporation's total debt eventually grew to approximately 4 million dollars, but was renegotiated down to approximately $600,000 in 1988. The corporation ceased operating in 1990, and the Taxpayer was required to personally satisfy the remaining loan balance of over $600,000.

The Taxpayer carried over the 1990 loss as an NOL deduction to 1993 and 1994. The Department disallowed the deductions based on its position that the 1990 loss was a non-business loss. This appeal followed.

As stated, the 1990 loss can be recognized for NOL purposes only if it was attributable to the Taxpayer's trade or business.

An employee of a corporation is in the trade or business of being an employee. Consequently, if the employee makes loans or loan guarantees on behalf of the corporation primarily to protect his job, the loans or guarantees are business-related. U. S. v. Generes, 92 S.Ct. 827 (1972); Trent v. CIR, 291 F.2d 669 (1961).

On the other hand, if the employee is also a shareholder in the corporation, the loans or loan guarantees are non-business if the shareholder's primary purpose was to protect or enhance his investment in the corporation, and not to protect his job. Whipple v. Commissioner, 83 S. Ct. 1168 (1963); Kelly v. Patterson, 331 F.2d 753 (1964); Betson v. CIR, 802 F.2d 365 (1986). This case thus turns on whether the Taxpayer guaranteed the loans to protect his job with the corporation, or to protect his investment and ownership interest in the corporation.

The corporation used the loan proceeds for both operating expenses and to expand. The evidence indicates, however, that the primary purpose for the loans was to expand the business by purchasing other businesses. The Taxpayer's representatives stated at the February 24, 1998 hearing as follows:

"Administrative Law Judge: So they borrowed money to expand the business?

Mr. Cork: Yes."

Transcript, at page 6.

> "Mr. Waide: The guarantees were made in connection with expansion of the business, buying another business, in order that they could - they thought they could manage a larger entity and that they could enhance their income, but more for the managerial efforts."

Transcript, at page 9.

The expansion of the business was not necessary for the Taxpayer to keep his job. Unlike the Trent case, where the employee was required to loan the corporation money or lose his job, the Taxpayer in this case guaranteed the loans primarily to protect and enhance the value of his ownership interest in the corporation, not to keep his job. Consequently, the 1990 loss must be treated as non-business.

The above conclusion is supported by the rules of construction that (1) a deduction must be construed for the government and against the taxpayer, and (2) the burden is on a taxpayer to prove his right to a claimed deduction. Ex parte Kimberly-Clark, 503 So.2d 304 (1986). For other cases involving the business versus non-business aspect of an NOL, see State v. Marks, INC. 93-145 (Admin. Law Div. 4/13/94); State v. Eady, INC. 92-147 (Admin. Law Div. 4/21/94); Smith v. Dept. of Revenue, INC. 95-346 (Admin. Law Div. 1/10/96).

A penalty assessed by the Department may be waived for reasonable cause. Code of Ala. 1975, §40-2A-11(h). Reasonable cause includes situations in which a taxpayer acts in good faith. This case involved a good faith dispute as to whether the 1990 loss was business or non-business. Consequently, the penalties are waived for reasonable cause.

The final assessments, less the penalties, are affirmed. Judgment is entered against the Taxpayers for 1994 income tax of $6,949.61, and 1993 income tax of $1,312.69, plus applicable interest.

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

Entered May 14, 1998.

BILL THOMPSON
Chief Administrative Law Judge

BT:ks

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