GIUSEPPE (DEC) & ELVIRA BERTOLONE 21 WEATHERLY CLUB DRIVE, STE. 500 ALABASTER, AL 35007,	§	STATE OF ALABAMA ALABAMA TAX TRIBUNAL
Taxpayers,	§	DOCKET NO. INC. 15-995 INC. 15-1237
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

FINAL ORDER

Giuseppe and Elvira Bertolone ("Taxpayers") filed a 2009 Alabama income tax return claiming, relevant to this appeal, (1) a $20,000 capital stock loss; (2) income of $242,500 from the cancellation of indebtedness reported on Schedule E as rents received; and (3) a $432,049 business bad debt deduction.

The Department audited the 2009 return and disallowed the stock loss, recharacterized the cancellation of indebtedness income as Schedule C gain, and disallowed the business bad debt deduction. The Department subsequently entered a preliminary assessment on June 22, 2012.

In June 2013, the Taxpayers petitioned for a review of the preliminary assessment and presented additional records. The Department subsequently allowed the previously disallowed stock loss and recharacterized the loan amounts as capital contributions which entitled the Taxpayers to a capital loss. Recharacterizing the loan amounts as capital contributions eliminated the Taxpayers' net operating loss ("NOL") in 2009. The Department issued the Taxpayers a refund of $84.

The Taxpayers appealed to the Tribunal pursuant to Code of Ala. 1975, §40-2A-(8)(b), on June 29, 2015, challenging the Department's recharacterization of the bad debt deduction. The Tribunal docketed that appeal as INC. 15-995.

On July 7, 2015, the Department assessed the Taxpayers for 2010 and 2011 Alabama income tax. The assessments resulted from the Department's recharacterization of the bed debt deduction and the disallowance of the NOL in 2009. The Taxpayers appealed the assessments to the Tribunal pursuant to Code of Ala. 1975, §40-2A-7(b)(5)a., on August 5, 2015. The Tribunal docketed that appeal as INC. 15-1237.

The Tribunal consolidated the cases and conducted a hearing on September 15, 2016. Attorney Gregory Rhodes represented the Taxpayer. Assistant Counsel Warren Young represented the Department.

The only issue in these appeals is whether the Taxpayers' advances to a wholly-owned corporation were, for tax purposes, loans or capital contributions.

The Taxpayers moved to the United States from Italy in 1997. They started a real estate business and invested in land in California to construct a building suitable for a restaurant. Although they had no credit, they were able to obtain financing with the help of a relative to construct the building. Within a few years of moving to the United States, the Taxpayers started a business together incorporated as Joe's Restaurant, Inc. (the "Corporation"). Together, through the Corporation, they opened a restaurant known as Joe's Restaurant ("Joe's Restaurant") in 1981, and operated it in some capacity until it closed in 2008. Additionally, throughout the years, the Taxpayers acquired various other properties which provided them with additional passive income.

The Taxpayers initially advanced funds to the Corporation to provide operating capital for Joe's Restaurant, and they periodically advanced additional funds to the Corporation to keep Joe's Restaurant open in times of financial distress. The Taxpayers worked at Joe's Restaurant until they sold the Corporation in 2007, a year before they

moved to Alabama. The Taxpayers paid themselves for use of the building, and paid themselves a salary when Joe's Restaurant was solvent enough to do so.

The Corporation only made a few, nominal payments on the loan from 1981 until 2009, the year it dissolved. The advances were made without any formalities—there were no written loan agreements, no repayment terms, and no interest for use of the funds. At the time of the Corporation's dissolution, the Taxpayers had advanced over $432,000 to the Corporation that was never repaid.

The Taxpayers assert that all of the advances were loans to the Corporation. They thus contend that they are entitled to a bad debt deduction in 2009 in the amount of $432,049. The Taxpayers further argue that the deduction is a business bad debt deduction because the advances were necessary to secure and maintain the Taxpayers salaries and to protect their investment in the building. For the reasons discussed below, I disagree.

Code of Ala. 1975, §40-18-15 provides a deduction for any bona fide debt that becomes worthless within a taxable year as follows:

> (a) In computing net income, there shall be allowed as deductions:
>
> (7) Losses from debts ascertained to be worthless and charged off during the taxable year of such ascertainment, if sustained in the conduct of the regular trade or business of the taxpayer during the period covered by an Alabama income tax law;

That section is, in substance, identical to the deduction allowed under federal law found at 26 U.S.C.A. 166(a). See also 26 C.F.R. Sec. 1.166-1(c), Income Tax Regs.

The burden is on the taxpayer to prove he is entitled to a deduction, and he must satisfy the specific requirements for any deduction he claims. *Sensenig v. Commissioner,*

T.C. Memo 2017-001 at 6 (2017). To be entitled to a bad debt deduction in a taxable year, a taxpayer must show (1) that the advances made were in fact a bona fide debt, (2) that the debt became worthless in the taxable year in which the deduction was claimed, and (3) that the debt was incurred in connection with a trade or business. *Id.*

When an Alabama statute is modeled after a similar federal law on the subject, interpretations and decisions relevant to the federal law are controlling in construing the Alabama statute. *Best v. State Dept. of Revenue*, 417 So.2d 197 (1981); *State v. Gulf Oil Corporation*, 256 So.2d 172 (Ala. Civ. App. 1971).

A capital contribution, by definition, is not a debt for purposes of §166. See C.F.R. Sec. 1.166-1(c). Relevant to the first requirement that advances must constitute a debt, the parties must have actually intended to establish a debtor-creditor relationship for a transaction to be a bona fide loan. *Fisher v. Commissioner*, 54 T.C. 905, 909-910 (1970). A bona fide debt arises from a "debtor-creditor relationship based on a valid and enforceable obligation to pay a fixed or determinable sum of money." *Kean v. Commissioner*, 91 T.C. 575, 594 (1988). Whether a debtor-creditor relationship exists "is a question of fact to be determined upon a consideration of all the pertinent facts in the case." *Fisher*, 54 T.C. at 909-910.

Where shareholders invest amounts of money in a closely-held or wholly-owned corporation and the corporation cannot repay the funds, the taxpayer must prove that the resulting loss was from a valid and legally enforceable obligation between the parties for the corporation to repay the funds. *Sensing*, T.C. Memo 2017-001; *Glass Blochs Unlimited v. Commissioner*, T.C. Memo 2013-180 (2013); *June Shaw v. Commissioner*, T.C. Memo

2013-170 (2013). As part of that burden, a taxpayer must prove that the agreement's terms and formalities are similar to those that would reasonably exist in an arms-length, debtor-creditor relationship. *See Id.* Further, courts analyze debts between related parties with closer scrutiny that other debts. *Glass Blochs*, T.C. Memo 2013-180.

To prevail in this appeal, the Taxpayers must prove that advances made to the Corporation created a debtor-creditor relationship based on a valid and enforceable obligation to repay the funds. To meet that burden, they must prove that the repayment terms and formalities were similar to those that would reasonably exist in an arms-length relationship. Because the Taxpayers have failed to prove that the advances they made to the Corporation constituted bona fide loans, the Tribunal need not and does not address the issues regarding the timing of the debt's worthlessness or whether the advances were made in connection with the Taxpayers' trade or business.

In *Shaw*, *supra*, the Tax Court analyzed the nature of a majority shareholder's advances to a closely held corporation and held that the advances were not debt because the shareholder failed to show that she had a reasonable expectation of repayment at the time the advances were made. T.C. Memo 2013-170. The court found that the taxpayer made advances to the corporation when the corporation was in financial distress. In its analysis, the court noted the long-standing principle that advances made to an insolvent debtor are not debts for tax purposes, but instead are characterized as capital contributions. *Id.* at 4. Finding that the taxpayer failed to show that the corporation was credit-worthy at the time the advances were made, the court held that the taxpayer could not prove that the funds were extended under the same types of terms that would

reasonably exist in an arms-length, debtor-creditor relationship. *Id.* Consequently, the court held that the bad debt deduction was properly disallowed.

In *Glass Blochs, supra*, a case decided by the Tax Court in the same year as *Shaw*, the court applied a factor-based test to evaluate the nature of advances made by the taxpayer to a closely-held corporation. T.C. Memo 2013-180. Among others, the court considered the following noteworthy factors: (1) the existence of formal written documents memorializing the loan agreement; (2) the presence or absence of a fixed maturity date; (3) the right to enforce payments; (4) the capitalization of the corporation; (5) the ability of the corporation to obtain financing from outside sources; (5) the failure of the corporation to repay; and (6) the risk involved in making the transfers. *Id.* at 4. The court found that there were no written agreements or promissory notes between the taxpayer and the corporation evidencing the loan. Further, the court found that there was no evidence that the taxpayer required interest for the use of the funds or that there was a fixed repayment schedule. After considering the lack of formalities that would have existed in an arms-length, debtor-creditor relationship, the court held that the advances were not loans. The court noted that when a taxpayer's expectation for repayment depends "solely on the success of the [corporation's] business, rather than on an unconditional obligation to repay, the transaction has the appearance of a capital contribution." *Id.* at 11-12. Consequently, the court held that the bad debt deduction was properly disallowed.

In *Sensenig*, *supra*, the most recent case involving taxpayer advances to a closely-held corporation, and perhaps the most instructive, the Tax Court employed the factor-based test applied by the U.S. Court of Appeals for the Third Circuit in *Fin Hay Realty Co.*

v. United States, 398 F.2d 694, 696 (3rd Cir. 1968) to evaluate the nature of the taxpayers' advances to their wholly-owned corporation. T.C. Memo 2017-001. The court noted that the factors outlined in *Fin Hay* fit into three categories: (1) the intent of the parties; (2) the form of the instrument; and (3) the objective economic reality of the transaction as it relates to the risks taken by investors. *Id.* at 8. After weighing the factors relevant in each category, the court determined that the advances were equity investments and not debt. *Id*.

With regards to the first and second categories, the absence of loan agreements providing for repayment of the advances carried great weight in the court's decision. *Id.* at 8-9. The court noted that the lack of any formality was unfavorable to the taxpayers' contentions that the advances were loans where there was no "provision for interest, no enforceable obligation to repay the funds advanced, no maturity date, and no provision for superiority." *Id.* at 8. The court also found it influential that the taxpayers never made a single, formal demand for repayment. *Id.* at 8-9. The court held that the absence of any documents and formalities typically associated with loans supported the conclusion that the advances were contributions of capital and not loans. *Id.* at 8-9 (quoting *Fischer*, 441 F. Supp. at 37, "conclusory declarations that the parties intended to create debts should carry little weight"; also quoting *Geftman v. Commissioner*, 154 F.3d 61, 68 (1998), "in the absence of direct evidence of intent, the nature of the transaction may be inferred from its objective characteristics.").

Turning to the third category, the economic reality of the advances, the court stated that the true nature of an asserted loan transaction may be ascertained by "measuring the

transaction against the 'economic reality of the marketplace' to demine whether a third-party lender would extend credit under similar circumstances." *Id.* at 10 (quoting *Geftman*, 154 F. 3d at 76). The court further stated that "if an outside lender would not have lent funds to the corporation on the same terms as did the insider, an inference arises that the advance is not a bona fide loan." *Id.* Noting the taxpayer's testimony that the corporations at issue were start-up ventures that could not obtain financing from unrelated banks, and that no prudent investor would have continued to make advances when the corporations had failed to repay any of the initial advances, the court held that the advances should be viewed as venture capital rather than loans. *Id.* (citing *Steiner v. Commissioner*, T.C. Memo 1981-212 (1981) (noting that where advances are placed at the risk of the business, they are typically viewed as contributions of capital rather than loans)). The court also considered the fact that the taxpayers' expectation of repayment was completely dependent on the future financial success of the corporations. *Id.* (citing *Scriptomatic, Inc. v. U.S.*, 555 F.2d 364, 368 (3d Cir. 1977) ("advances [are] not debt where repayment can only be reasonably assured by the chance of profits or from the liquidation of the business.")).

Final assessments entered by the Department are prima facie correct, and the taxpayer bears the burden of proving that an assessment is incorrect. Code of Ala. 1975, §40-2A-7(b)(5)c. In this appeal, the Taxpayers have failed to show that the advances they made to the Corporation were made under the same types of terms that would reasonably exist in an arms-length, debtor-creditor relationship. The evidence shows that the advances do not resemble loans that would entitle the Taxpayers to a bad debt deduction.

Like the taxpayers in *Glass Bloch, Shaw, and Sensenig*, the Taxpayers have failed to prove that the advances were bona fide loans. The Taxpayers advanced funds to the Corporation without written loan agreements, without repayment terms and without the accrual of interest. No reasonable third-party lender would have advanced funds to the Corporation where no objective attributes giving rise to an enforceable obligation of repayment—those which denote a bona fide loan—are present.

Further, there is no evidence that the Corporation was credit-worthy when the Taxpayers made the initial advances in 1981. In fact, it is undisputed that the Taxpayers made the initial advances in order for Joe's Restaurant to begin operations—a fact denoting the advances are capital contributions rather than loans. Additionally, the Taxpayers continued to make advances to the Corporation, even though it had only repaid a nominal amount of the loan. Further, the Taxpayers made those additional advances at a time when the Corporation was in financial distress. Such advances were objectively risky, and the Taxpayers could only have expected to be repaid when Joe's Restaurant was profitable enough to have additional capital remaining after covering its operating expenses.

Given the fact that the Corporation never repaid anything more than a nominal amount from 1981 to 2008, the Taxpayers had no reasonable expectation that it would repay the loans. Further, there is no evidence that that the Taxpayers ever made a formal demand for payment. No reasonable third-party lender would have lent funds to the Corporation under these circumstances. The Taxpayers have presented no evidence to overcome the inference that the advances were capital contributions.

After weighing the objective characteristics of the advances, and considering the economic realities of making loans, I conclude that the nature of the advances were capital contributions and not loans. The Department correctly characterized the advances as capital contributions and properly allowed a capital loss.

The Department's denial of the Taxpayers' NOL in 2009 is affirmed, and the resulting final assessments for tax years 2010 and 2011 entered on July 7, 2015 are affirmed. Judgment is entered against the Taxpayers for tax, penalties and interest, in the amount of $6,558.25, and $9,858.15, respectively. Interest will continue to accrue from the date the final assessments were entered, July 7, 2015.

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

Entered February 1, 2017.

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CHRISTY O. EDWARDS
Associate Tax Tribunal Judge

cc: Warren W. Young, Esq.
Gregory P. Rhodes, Esq.