ALABAMA TAX TRIBUNAL

CAMPBELL B., IV & AMELIA R. LANIER,	§	
Taxpayers,	§	DOCKET NO. INC. 17-268-LP
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

FINAL ORDER

This appeal involves a final assessment of 2014 Alabama income tax entered against the above Taxpayers. A hearing was conducted by Tax Tribunal Associate Judge Christy Edwards on November 27, 2017. David Humber represented the Taxpayers. Assistant Counsel Ralph Clements represented the Alabama Department of Revenue. Pre-hearing and post-hearing briefs were filed by both parties.

This appeal stems from the Revenue Department's disallowance of a bad debt deduction claimed by the Taxpayer for tax year 2014.

FACTS

Island Pond Plantation, LLC (the "LLC"), was founded in 2007 for the purpose of purchasing recreational real property, enhancing it, and selling it. The LLC was owned by two members, each with 50 percent ownership: the 1997 Trust FBO Campbell B. Lanier, IV (the "Trust"), and Paul W. Bryan. On March 30, 2007, the LLC purchased a piece of real property in South Georgia typical of quail hunting property (the "Property"). The purchase price was approximately $7.5 million and was financed 100 percent by Thomasville Bank.

Campbell B. Lanier, IV (individually, the “Taxpayer”), came into the venture with many years of experience buying and selling properties similar to the Property. Mr. Bryan brought experience improving hunting plantations.

Initially, the Trust and Mr. Bryan invested funds equally into the LLC for the maintenance and improvement of the Property as well as interest-only payments due on the Mortgage.

The goal of the project was to sell the Property as a turnkey operation. Thus, there were two employees (1 full-time, 1 part-time), dogs, horses, etc., common to this type of recreational destination. As such, the members paid these expenses in hopes that the Property would sell at top dollar.

In 2009, Mr. Bryan communicated to the Taxpayer that he did not have the funds to contribute to the LLC, although funding was still required to improve the Property and pay the Mortgage. Therefore, the Taxpayer, individually and not through the Trust, loaned money to Mr. Bryan to fully fund Mr. Bryan’s portion of the required member contributions into the LLC.

On September 3, 2009, Mr. Bryan executed a Commercial Promissory Note (the “Note”) in favor of the Taxpayer for $204,933.33, which represented Mr. Bryan’s portion of the annual interest payment on the Mortgage (~$187,000) and part of Mr. Bryan’s portion of a capital call (~$17,000). Additionally, Mr. Bryan executed a Subordinated Deed to Secure Debt and Security Agreement, indicating that Mr. Bryan would transfer to the Taxpayer “an undivided one-half” interest in the Property to secure payments of the Note. The Note matured on “May 23, 2011, or upon sale of property.”

Mr. Bryan managed the Property and contacted the Taxpayer's office periodically to inform him of the cost of the operating expenses, including Mr. Bryan's unmet portion. The Taxpayer, or someone on his behalf, would write a check to Mr. Bryan for his portion of the expenses as further loaned funds, although some checks were made payable to Thomasville Bank and some to the LLC, with some indication that the check was a loan to fund Mr. Bryan's share. This continued for several years with the total amount loaned reaching approximately $1.3 million. The Note document was never amended.

The Property was purchased in 2007 with the intent to quickly flip it, which included improving both the land and buildings. About nine months into the project, the house on the Property burned in an electrical fire. Around this time, the 2008 recession began, decreasing the value of the Property. The parties involved decided to hold the Property and continue improving it, including building a new house, until the value increased.

In 2014, the parties decided to sell the Property in order to halt further investment in the Property. All proceeds from the sale were directed to Thomasville National Bank to pay the Mortgage on the Property. However, the proceeds did not satisfy the Mortgage. In order to close on the sale of the Property, the Taxpayer and Mr. Bryan executed a note to the bank for the difference between the selling price and the mortgage balance, approximately $200,000 - $300,000. The LLC had no assets to pay the balance.

Mr. Bryan could not pay his loan back to the Taxpayer after the sale of the Property.

The Taxpayer claimed a bad debt deduction of $1.3 million in 2014 under § 40-18-15(a)(5) of the Alabama Code. The Taxpayer testified that the loan he made to Mr. Bryan was made with the intention that Mr. Bryan would repay it in full upon the sale of the Property, which was expected to yield a profit. Up until the claiming of this deduction, the Taxpayer, through his accountant, treated the loaned funds as an asset to the Taxpayer.

The Department argued that the note to Mr. Bryan was exchanged at closing for the value of his working for the purchaser for three years. Testimony was provided that although Mr. Bryan agreed to work for the purchaser, that agreement was not part of the sale of the Property and no value was assigned to it.

ISSUES

In its post-hearing brief, the Department argued that, in addition to the reasons set forth in its Answer and pre-hearing brief, the Taxpayer was not entitled to a deduction under Ala. Code §40-18-15(c)(5) because he was domiciled in Georgia. In its Answer and pre-hearing brief, the Department denied the deduction based on the following contentions:

1. To the extent there was a debt, it became worthless prior to 2014;
2. To the extent the alleged debt exceeds the $204,933.33 stated on the Note, there was no debt because the Georgia Statute of Frauds prevents enforcement of such excess amounts.
3. The alleged debt did not become worthless but was exchanged for value as Mr. Bryan promised to work for the buyer following the sale of the Property.

ANALYSIS

The Taxpayer argues that it is entitled to the deduction for the worthless debt under Ala. Code § 40-18-15(a)(5) or alternatively, under Ala. Code § 40-18-15(a)(7).

Section 40-18-15(a)(5) allows a deduction from individual income tax for:

> Losses sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in any transaction entered into for profit, though not connected with the trade or business in accordance

> with 26 U.S.C. §165(c)(2); but, in the case of a taxpayer other than a resident of the state, only as to those transactions within the state.

Ala. Code § 40-18-15(a)(5).

The Department argues that this section does not apply as the Taxpayer was domiciled in Georgia in 2014 and the relevant prior years. However, the Taxpayer's representative submitted to the Tribunal that the Taxpayer was an Alabama resident in 2014 and filed a 2014 Form 40 Alabama Individual Income Tax Return for Residents and Part-Year Residents. A copy of that return was filed with the Tribunal and indicates that the Taxpayer was a full-year Alabama resident. The Department presented no evidence to contradict this. The Taxpayer was not disqualified from taking a deduction under § 40-18-15(a)(5) due to residency, and the Department does not argue that the loss was not related to a transaction entered for profit.

Thus, we now turn to the issues presented in the Department's Answer and pre-hearing briefs.

ISSUE 1

The first question is the timing of the deduction. The Taxpayer claimed the deduction in 2014 when the Property was sold. The Taxpayer contends that because the Note was secured by Mr. Bryan's share of the Property, the debt was not worthless until the Property sold and Mr. Bryan told the Taxpayer he did not have money to repay him. The Taxpayer cited Treas. Reg. § 1.166-2, Evidence of Worthlessness. 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). Thus, we look to 26 U.S.C. §165(c)(2) and related law for application in this case.

Under Treasury Regulation § 1.166-2, the general rule is that "all pertinent evidence, including the value of the collateral, if any, securing the debt and the financial condition of the debtor" will be considered to determine whether a debt is worthless. Treas. Reg. § 1.166-2(a). Furthermore, if the facts indicate that legal action to collect the debt is unlikely to be fruitful, then legal action is not required to prove worthlessness. Treas. Reg. § 1.166-2(b).

As cited in *Byal*, "To be deductible, nonbusiness bad debts must be totally worthless. You cannot deduct a partially worthless nonbusiness bad debt." *Byal* at 4, quoting IRS Publication 17. *See also* Treas. Reg. §1.166-5(a)(2) ("A loss on a nonbusiness debt shall be treated as sustained only if and when the debt has become totally worthless, and no deduction shall be allowed for a nonbusiness debt which is recoverable in part during the taxable year.").

The Taxpayer did not employ legal action to enforce payment on the debt. However, testimony, along with the value of the Property as collateral, indicates that the debt became wholly worthless in 2014. Testimony showed that the Taxpayer did not learn that Mr. Bryan could not repay any of the loaned funds until after the closing of the sale of the Property. Additionally, the Taxpayer's Exhibit 2 contained emails documenting phone calls from Mr. Bryan in the weeks leading up to the sale closing where Mr. Bryan told the Taxpayer's employee that "he will know what's left" after closing, and "[a]nything left, he will balance out at the end," indicating that there may be funds at closing to repay some of the loan. Therefore, the Tribunal concludes that the debt became wholly worthless in 2014 and was properly deducted in that year.

<u>ISSUE 2</u>

Next, the Department contends that the Georgia Statute of Frauds prevents the entire $1.3 million from being a bona fide debt for purposes of the deduction and that only the amount documented on the Note ($204,933.33) is a proper debt. The Taxpayer argues that the loan does not fall under the Georgia Statute of Frauds because it was not a mortgage on land or other real property. Rather, the loan was intended to be used for working capital. Even if it were a loan for real property, the Taxpayer states that the Georgia Statute of Frauds would not apply because "[t]he Statute of Fraud does 'not extend to the following cases: … (2) Where there has been performance on one side, accepted by the other in accordance with the contract; (3) Where there has been such part performance of the contract as would render it a fraud of the party refusing to comply if the court did not compel performance.' OCGA § 13-5-31. See generally *Wilson v. Whitmire,* 212 Ga. 287, 290, 92 S.E.2d 20 (1956). See *Rose v. O'Brien*, 380 S.E.2d 730, 731 [Ga. App. 1989]." In *Rose,* the court stated the following:

> Appellee also argues that he was entitled to summary judgment on the ground that since the alleged promise to pay was not to be performed within a year, enforcement of the promise is barred by the Statute of Frauds. OCGA § 13-5-30(5). However, appellant has sworn that he fully performed his part of the bargain he asserts existed between the parties by advancing the money to appellee. The Statute of Frauds does "not extend to the following cases: ... (2) Where there has been performance on one side, accepted by the other in accordance with the contract; (3) Where there has been such part performance of the contract as would render it a fraud of the party refusing to comply if the court did not compel a performance." OCGA § 13-5-31. See generally *Wilson v. Whitmire,* 212 Ga. 287, 290, 92 S.E.2d 20 (1956). If appellant's version of the facts of this case were to be accepted by a jury, enforcement of the promise to pay would not be barred by the Statute of Frauds.

Id. The appellant's version of the facts in *Rose* were that "the parties had an agreement for a continuing loan to be made, that repayment was to be made when appellee could or when appellant made demand for repayment a reasonable time in the future, and that appellant had made a demand within the period of limitation and less than four years before bringing suit." *Id.* Similarly, the record in the case at issue reveals that the parties had an agreement for a continuing loan to be made and to be repaid when Mr. Bryan was able or upon the sale of the Property and that the Taxpayer loaned the funds which were accepted by Mr. Bryan. Therefore, the Georgia Statute of Frauds would not bar the enforcement of the debt owed by Mr. Bryan to the Taxpayer.

This conclusion is not changed by the Department's argument that oral modification of a promissory note violates the Parol Evidence Rule. The cases cited by the Department speak to the terms of the contract and not whether one party has performed and the other has accepted such performance.

ISSUE 3

The Department's third contention was that the debt was exchanged for the value of Mr. Bryan's promise to work for the buyer for three years following the closing of the sale of the Property. At the hearing, the Department agreed this did not occur, as the promise was made to the buyer by Mr. Bryan and was not a condition of closing the sale.

CONCLUSION

The facts indicate that the Taxpayer was qualified to claim the deduction under Ala. Code §40-18-15(a)(5) in 2014. Judgment is entered for the Taxpayers. The Final Assessment is hereby voided.

This Final Order may be appealed to circuit court within 30 days, pursuant to Ala. Code § 40-2B-2(m).

Entered December 5, 2019.

/s/ Leslie H. Pitman
LESLIE H. PITMAN
Associate Tax Tribunal Judge

lhp:dr

cc: David Humber, Esq.
Ralph C. Clements, III, Esq.