

HUBERT W., SR. & HELEN R. TOOLE §
P.O. Box 1729
Dothan, AL 36302, §
DIVISION

STATE OF ALABAMA
DEPARTMENT OF REVENUE
ADMINISTRATIVE LAW

Taxpayers, § DOCKET NO. INC. 00-419

v. §

STATE OF ALABAMA §
DEPARTMENT OF REVENUE.

FINAL ORDER

The Revenue Department assessed 1993 income tax against Hubert W., Sr. and Helen R. Toole (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 13, 2001. David Johnston and CPA Rod Andrews represented the Taxpayers. Assistant Counsel Mark Griffin represented the Department.

ISSUE

The issue in this case is whether a loss incurred by Hubert W. Toole (individually "Taxpayer") in 1986 can be carried over as a net operating loss ("NOL") to 1993. That issue turns on whether the loss was a business loss or a nonbusiness loss for purposes of the NOL modification at Code of Ala. 1975, §40-18-15(a)(16)f.3.¹ That section provides that nonbusiness losses can only be used to offset nonbusiness income. Consequently, if the 1986 loss was nonbusiness, it cannot be carried over to 1993.

FACTS

¹The NOL deduction was codified at §40-18-15(a)(16) during the years in issue. The current NOL deduction is at Code of Ala. 1975, §40-18-15.2.

The Taxpayer and his brother started Bama Truck and Farm Equipment Company, Inc. ("Bama Truck" or "corporation") in 1961. The Taxpayer initially invested \$13,500 in the corporation. The Taxpayer purchased his brother's interest in 1979, and thereafter was sole owner of the business.

Bama Truck began losing money in the late 1970s due to high interest rates and a slow down in large truck sales. Consequently, the Taxpayer loaned the corporation approximately \$43,000 in 1977 to meet its operating expenses. Bama Truck continued to lose money, and the Taxpayer loaned the corporation a total of over \$850,000 from 1977 through 1985.² The Taxpayer's annual salary from Bama Truck averaged approximately \$25,000 during those years.

The Taxpayer also invested in commercial real estate over the years. He primarily renovated existing buildings and built new buildings, which he either rented or sold. At one time, the Taxpayer owned over 43 buildings in the Dothan area. The Taxpayer realized capital gains of over \$1,275,000 from the sale of real estate from 1981 through 1986. The Taxpayer obtained the money he loaned to Bama Truck from his real estate rental income, the sale of real estate, and from loans secured by the real estate.

The Taxpayer sold the inventory and equipment of Bama Truck in 1983 for \$400,000. Most of the proceeds were used to pay the corporation's debts and loans to the corporation that the Taxpayer had personally guaranteed. The Taxpayer agreed to sell only after the purchaser agreed to retain most of the corporation's employees. The other employees continued to work for the Taxpayer. The Taxpayer continued operating the corporation from 1983 until

²The specific loan amounts were \$43,775 in 1977, \$94,323 in 1978, \$47,916 in 1979, \$247,149 in 1980, \$2,037 in 1981, \$6,545 in 1982, \$239,269 in 1984, and \$178,379 in 1985.

1986 for the purpose of selling the trucks he had repossessed from defaulting customers.

The Taxpayer liquidated the corporation in 1986.³ The Taxpayers claimed a \$695,000 loss on their 1986 Alabama return based on the Taxpayer's loans to the corporation that were not repaid. The Taxpayers subsequently carried over the loss as an NOL to 1993. The Department disallowed the carryover. The Taxpayers appealed.

ANALYSIS

An employee's job with a corporation is the employee's trade or business. Consequently, if an employee makes a loan to a corporation primarily to protect his job, the loan is business in nature. But if the employee is also a shareholder in the corporation, a loan to the corporation is nonbusiness if his motive is to protect his investment in the corporation, and not his job. An unpaid loan to a corporation can be treated as a business loss only if the taxpayer's dominant motive in making the loan was to save his job. See generally, *In re Mills*, 189 B.R. 707 (W.D. Tenn. 1995); *Betson v. C.I.R.*, 802 F.2d 365 (9th Cir. 1986), *U.S. v. Generes*, 92 S.Ct. 827 (1972), and *Whipple v. Commissioner*, 83 S.Ct. 1168 (1963); see also, *Nancy G. Smith v. State of Alabama, Inc.* 95-346 (Admin. Law Div. 1/10/96), *State of Alabama v. Eady, Inc.* 92-147 (Admin. Law Div. 4/21/94), and *State of Alabama v. Marks, Inc.* 93-145 (Admin. Law Div. 4/13/94).

The Taxpayer argues that he loaned the corporation over \$850,000 from 1977 through 1985 to protect his \$25,000 salary from the corporation. The facts, including the Taxpayer's own testimony, prove otherwise.

³The Taxpayer has continued to operate his successful real estate business since 1986.

The Taxpayer claims he relied on his salary to pay his bills. (R.19.) It is clear, however, that he also received a large income from his real estate holdings. The Taxpayer testified that his real estate activities “could have been” his primary source of livelihood. (R. 21.) He used the income and assets of his real estate business to keep the corporation afloat. It is not feasible that the Taxpayer loaned the corporation over \$850,000 from 1977 through 1985 with the dominant motive of protecting his relatively small salary. Rather, the Taxpayer testified that his primary motive was to preserve his good reputation with the local banking community, and to insure that his employees kept their jobs. (R. 72, 79.)

The Taxpayer was and is a hard working, dedicated individual. He is not a quitter. (R. 42, 79.) He took pride in his business reputation, and the fact that his successful business grew from three employees in 1961 to 37 in the 1980s. He loaned the corporation money primarily to protect that reputation and his employees’ jobs, not his \$25,000 salary. He also personally owned the building in which the corporation operated, and thus benefitted from that investment as long as the corporation operated and paid rent. While his salary was one motive the Taxpayer had for keeping the corporation operating, it certainly was not his dominant motive, as required for the unpaid loans to be considered business losses. The losses in issue thus must be treated as non-business losses. For a similar result, see, *In re Mills*, supra.

The final assessment in issue is affirmed. Judgment is entered against the Taxpayers for \$21,831.12, plus additional interest from the date of entry of the final assessment, June 21, 2000.

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

Entered March 27, 2001.