

STATE OF ALABAMA, § STATE OF ALABAMA  
V. § DEPARTMENT OF REVENUE  
RICHARD A. & OUIDA HANN § ADMINISTRATIVE LAW DIVISION  
1905 Yellow Leaf Circle §  
Chelsea, AL 35043, § DOCKET NO. INC.85-115  
Taxpayers. §

ORDER

This matter involves a disputed preliminary assessment of 1980 income tax entered by the Revenue Department against Richard A. and Ouida Hann (Taxpayers). A hearing was conducted by the Administrative Law Division on May 20, 1985. The Taxpayers were represented at said hearing by attorney William D. Nichols. The Department was represented by assistant counsel Mark Griffin. Based on the evidence submitted by the parties, the following findings of fact and conclusions of law are hereby made and entered.

FINDINGS OF FACT

At issue in this case is the deductibility of a \$16,718.59 bad debt deduction claimed by the Taxpayers for the calendar year 1980. The Internal Revenue Service disallowed the claimed loss and adjusted the Taxpayers' federal liability accordingly. Thereafter, based on the IRS adjustments, the Revenue Department also disallowed the bad debt loss and adjusted the Taxpayers' liability. The preliminary assessment in issue is based on said disallowance. The facts relating to the disputed bad debt deduction are as follows: In 1978, Noelle', Inc. was incorporated in Georgia for the

purpose of designing and making handbags. The corporation's president was Mr. Tom Smith, who was in 1978 and is presently the son-in-law of the Taxpayers. The vice-president of the corporation was Ms. Shirley Temple, who is unrelated to the Taxpayers. Mr. Smith and Ms. Temple each owned fifty percent of the corporation's stock.

On September 13, 1978, Ouida Hann loaned \$16,718.59 to Noelle', Inc., Tom Smith (Individually) and Shirley Temple (Individually). A promissory note was executed indicating the liability of Noelle', Inc., Tom Smith (Individually) and Shirley Temple (Individually) to repay said sum, with interest accruing at eight percent from the date of the loan. The due date as indicated on the bottom of the promissory note was December 12, 1978. The loan proceeds were used to pay the start-up and initial operating expenses of the corporation.

The corporation operated with limited success until 1980, at which time it ceased operations. No formal dissolution has ever occurred. The Taxpayers' attorney, Mr. William Nichols, indicated at the hearing that Mr. Smith, along with the Taxpayers' daughter, presently live in New York. Mr. Nichols also indicated that Mr. Smith is presently insolvent and has been for some years, and that any attempt to collect the amount due from Mr. Smith would be useless. No attempt had been made by the Taxpayers to collect the amount due from the Mr. Smith.

Concerning Ms. Temple, there is evidence to indicate that

Noelle', Inc. executed a document which purported or attempted to release Ms. Temple from the promissory note. The present whereabouts and financial circumstances of Ms. Temple are unknown. No attempt had been made by the Taxpayers to collect the amount due from Ms. Temple.

#### CONCLUSIONS OF LAW

Code of Alabama 1975, §40-18-15, provides for a bad debt deduction 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 federal deduction for bad debts found at 26 U.S.C.A. , §166. Where a state statute is identical in content to a federal statute, interpretations and decisions relevant to the federal law should be followed in cases pertaining to the similar state statute. State v. Gulf Oil Corporation, 256 So.2d 172.

In general, the burden of proving a bad debt deduction is on the one claiming it. Wilson v. U.S., 376 F. 2d 280; Wortham Machinery Company v. U.S., 521 F.2d 160. While it has been held that the filing of a legal action for collection of a debt is not absolutely necessary to establish that the debt is worthless, Smith v. Barneson, 181 F.2d 280, as a general rule, the creditor must

exhaust every reasonable means of collection before a bad debt deduction is allowed. Bell v. U.S., 120 F.Supp. 931, affirmed 217 F.2d 646. In any case, and at the very least, in the absence of a suit to collect the amount due, there must be evidence that any action to collect the debt would have been unsuccessful. Dustin v. C.I.R. 467 F.2d 47.

As to the timing of a bad debt deduction, the burden is on the taxpayer to establish that the debt became worthless during the tax year. Wilson v. U.S., supra. There must be some event in the tax year, such as a suit to collect the debt or a change in the debtor's financial position, to allow the write-off in that year, Herskovits v. C.I.R., 110 F.2d 272, and if the debtor is insolvent at the beginning of the tax period, the debt cannot become worthless during the year. W. F. Young, Inc. v. C.I.R., 120 F.2d 159.

In the present case, the Taxpayers made the loan in furtherance of a venture headed by their son-in-law. In return, the son-in-law and an unrelated individual signed an unsecured promissory note making themselves individually liable to repay the loan in 90 days (December 12, 1978). There is no evidence that the note was renewed at the end of the 90 days.

The corporation apparently operated without notable success until 1980, at which time it ran out of money and ceased operations. Thereafter, the son-in-law and the Taxpayers' daughter moved to New York, where they presently live. The whereabouts of

the co-signer of the note, Ms. Temple, is not known.

The evidence indicates that the Taxpayers have at no time attempted to collect the amount due from either party. While no evidence was introduced as to Ms. Temple's past or present financial status, the statements of Mr. Nichols would indicate that from the beginning of the venture in 1978 until present, Mr. Smith has for all practical purposes been insolvent.

While it is not required that formal collection proceedings be instigated, there must be evidence to establish that such action would be unfruitful. There is evidence indicating that any action against Mr. Smith may be useless. However, there is no evidence as to Ms. Temple's financial condition, or whether the Taxpayers have ever made any effort to investigate the possibility of collecting the debt from Ms. Temple. If the Taxpayers could collect from either party, then the debt is not worthless. In the absence of legal action, there must be evidence to show that such action would be futile. No such evidence is present in the case at hand.

In addition, it would appear from the evidence that Mr. Smith was insolvent at the time the loan was made in 1978. As stated above, for a taxpayer to claim a bad debt deduction, the debt must become worthless during the tax year. Thus, because the note (debt) was worthless at the time it was made, as opposed to 1980, the deduction should be disallowed for that year.

Based on the above findings and conclusions, it is hereby determined that the bad debt in dispute is not deductible under

§40-18-15(7). Accordingly, the adjustments of the Revenue Department are correct and the final assessment is due to be affirmed.

Done this the 22nd day of August, 1985.

BILL THOMPSON  
Chief Administrative Law Judge