

STATE OF ALABAMA  
DEPARTMENT OF REVENUE,

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STATE OF ALABAMA  
DEPARTMENT OF REVENUE  
ADMINISTRATIVE LAW DIVISION

§

v.

§

DOCKET NO. INC. 90-233

RAYMOND J. & MARY R. RIHA  
3356 North Wildwood Drive  
Pelham, AL 35124,

§

§

Taxpayers.

§

FINAL ORDER

The Revenue Department assessed income tax against Raymond J. & Mary R. Riha (Taxpayers) for the year 1988. The Taxpayers appealed to the Administrative Law Division and a hearing was conducted on August 28, 1990. Carla G. Harrison and E. O. Browder, Jr. appeared for the Taxpayers. Assistant counsel Dan Schmaeling represented the Department. This Final order is based on the evidence submitted by the parties.

FINDINGS OF FACT

The Taxpayers each loaned \$200,000 to Southern Resistance Welding Company in January, 1984. Southern Resistance Welding was owned and operated by the Taxpayers' son, Raymond R. Riha. The loans were evidenced by two promissory notes for \$200,000 each signed on January 25, 1988 by Raymond R. Riha as president of Southern Resistance Welding. The notes required interest due at 10% to be paid monthly, with principal due on or after January 25, 1988. At the time of the loans, Southern Resistance Welding was a profitable, growing business.

Southern Resistance Welding paid the monthly interest of

\$1,666.66 on each note until December 1987, when the company filed a petition in bankruptcy.

The Taxpayers filed a claim with the Bankruptcy Court as unsecured creditors, but were notified in 1988 that the corporation's assets were insufficient to pay the notes. The Taxpayers subsequently claimed a \$400,000.00 nonbusiness bad debt deduction on their joint 1988 Alabama income tax return. The Department audited the Taxpayers, denied the bad debt deduction and subsequently entered the preliminary assessment in issue.

#### CONCLUSIONS OF LAW

Code of Ala. 1975, §40-18-15(a)(5) allows a deduction for losses "incurred in any transaction entered into for profit, though not connected with the trade or business; . . ." The issue in this case is whether the loans to Southern Resistance Welding were "entered into for profit" so that the losses resulting therefrom can be allowed as a deduction under the above section.

Loans between family members must be subjected to rigid scrutiny to determine if the loan is a gift rather than a bona fide debt. However, losses resulting from intrafamily loans can be allowed as a nonbusiness bad debt if the transaction is at arms length, is reasonable as to the percentage of interest charged, and if there is a reasonable expectation of repayment. Rogers v. Commissioner, T.C. Memo 1985-220.

In this case the loans were evidenced by two promissory notes requiring monthly payments of 10% interest. and repayment of the

principal in four years. The interest was paid each month until December, 1987. The Taxpayers could also reasonably have expected for the notes to have been repaid because when the loans were made the company was a profitable and growing concern. The above facts indicate that the loans were at arms length and that the Taxpayers had a reasonable expectation that Southern Resistance Welding would meet the monthly interest payments and would repay the principal amounts when due. There is no evidence that the Taxpayers intended for the loans to be gifts or that the Taxpayers did not expect payment in full on the notes. Accordingly, the loss on the defaulted notes should be allowed as a nonbusiness bad debt.

The above considered, the Department is directed to reduce and make final the assessment in issue showing no additional tax due.

Entered this 9th day of October, 1990.

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BILL THOMPSON  
Chief Administrative Law Judge