STATE OF ALABAMA DEPARTMENT OF REVENUE,	§	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
v.	§	DOCKET NO. INC. 91-185
MICHAEL A. & VIVIAN D. FIGURES 308 Cedar Drive Mobile, AL 36617,	§	
Taxpayers.	§	

FINAL ORDER

The Revenue Department assessed income tax against Michael A. and Vivian D. Figures (Taxpayers) for the years 1988 and 1989. The Taxpayers paid the tax and then appealed to the Administrative Law Division for a refund. A hearing was conducted on October 22, 1991. Michael A. Figures (Taxpayer) represented the Taxpayers. Assistant counsel Dan Schmaeling appeared for the Department. This Order is based on the evidence and arguments presented by the parties contained in the transcript of the hearing along with exhibits and the Recommended Order of the Administrative Law Judge.

FINDINGS OF FACT

This case involves two issues: (1) should the Taxpayers be allowed a bad debt deduction in 1989, and (2) should the Taxpayer be taxed an retained earnings received from liquidating corporation in 1988.

(1) The Bad Debt Deduction.

The Taxpayers are the principal stockholders in a corporation, The New Times Group, Inc. The corporation was formed in 1981 and

publishes a weekly newspaper. The Taxpayer's wife is primarily responsible for operating the newspaper.

The newspaper lost money and because of poor credit was unable to obtain outside financing. Consequently, to help the corporation the Taxpayer, a practicing attorney, wrote five personal checks on behalf of the corporation from June, 1983 through November, 1984. The checks totaled $14,421.57 and were used primarily to pay off bank loans that had been personally guaranteed by the Taxpayer.

To acknowledge the payments, the corporation issued a promissory note to the Taxpayer for $14,421.57 on December 18, 1984. The note was payable in full an November 8, 1985 with 14% interest.

The Taxpayer paid off another bank loan for the corporation an February 5, 1985 totaling $2,155.00 and took back a second promissory note in that amount, again at 14% interest and payable in full on November 8, 1985.

The corporation failed to pay the notes when due. The Taxpayer took no action to collect because he knew that the corporation could not pay. The corporation continued to operate and Incurred losses of §10,508.00 in 1986, $9,462.00 in 1987, and $3,822.00 in 1988. The corporation reported a profit of $5,205.00 in 1989. The corporation is still in business, although no evidence was submitted as to its profitability in 1990 or 1991.

The Taxpayers claimed the two promissory notes as bad debts on their 1989 Alabama return. The Taxpayers argue that the notes

became worthless in 1989 because (1) the corporation was unable to obtain adequate advertising revenues and (2) a long-time employee of the corporation left the company in that year, both of which made repayment of the notes unlikely.

The Department denied the bad debt deduction, primarily because the Taxpayers failed to prove that the debt became worthless in 1989. The Department contends that if at all, the deduction should have been claimed in 1985, the year in which the notes became due.

(2) The Retained Earnings.

Prior to 1988, the Taxpayer practiced law through a corporation, Figures, Ludgood and Figures, P.C. The corporation dissolved and was restructured as a partnership in February, 1988. The corporation's retained earnings of $4,691.00 were transferred to the Taxpayer's capital account in the new partnership. The Department treated the disbursement as taxable income to the Taxpayer. The Taxpayer objects that the retained earnings have already been taxed and should not be taxed again.

CONCLUSIONS OF LAW

The bad debt deduction claimed by the Taxpayers must be denied for the following reasons, any one of which is adequate to support the denial: (1) The debts were non-business and therefore not deductible under Alabama law; (2) The advances by the Taxpayer were contributions to capital and not arms-length loans; and (3) The

Taxpayer failed to establish that the "loans" became worthless in 1989.

First, unlike federal law, under which both business and nonbusiness bad debts can be deducted, see 26 U.S.C. §166, Alabama law allows a deduction for only bad debts "sustained in the conduct of the regular trade or business of the taxpayer", see Code of Ala. 1975, §40-18-15(a)(7). The Taxpayer in this case is not in the regular trade or business of making loans. Consequently the transactions were not business related and therefore not deductible under Alabama law.

Second, advances by a shareholder to a corporation must be closely analyzed to determine if they are (1) arms-length loans, or (2) contributions to capital. If the transaction does not involve a true debtor-creditor relationship, the payments must be treated as contributions to capital by the shareholder and a subsequent bad debt deduction cannot be allowed. Aronov Const. Co. v. U.S., 223 F.Supp. 175 (1963).

The criteria to be considered in distinguishing between equity and debt is set out in Tomlinson v. 1161 Corporation, 377 F.2d 291 (1967); see also Estate of Mixon v. U.S., 464 F.2d 394 (1972) and Texas Farm Bureau v. U.S., 725 F.2d 307 (1984). In summary, to constitute a bona fide loan the transaction must be handled in an arms-length, business-like manner and there must be a reasonable expectation that the principal plus interest will be paid upon

maturity.

In this case, the payments by the Taxpayer were not bona fide loans to the corporation. The Taxpayer made the first five payments from June, 1983 through November, 1984, but didn't see fit to document the "loans" until late December, 1984. The Taxpayer knew the poor economic condition and profit history of the corporation when he made the advances and could not have expected as a prudent businessman that the loans plus interest would be paid on the due date. Also, the notes were not formally extended and the Taxpayer took no action to collect when the notes came due. While the Taxpayer certainly wanted to be repaid, it is equally clear that in making the advances he was more interested in helping the corporation than in obtaining a reasonable return on his money. See Texas Farm Bureau v.U.S., supra, at page 314. Under the circumstances, the advances must be classified as contributions to capital by the Taxpayer.

Finally, even if the advances had been business related, arms-length loans, the Taxpayer failed to prove that the loans became worthless in 1989. To claim a bad debt deduction in a given year, the taxpayer must show (1) that the debt had some value at the beginning of the tax year, and (2) that the debt became worthless during the tax year. Levin v. U.S., 597 F. 2d 760 (1979).

The evidence, if viewed objectively, shows that the Taxpayer had no reasonable expectation of collecting on the notes prior to

1989. The newspaper lost money from 1981 through 1985. The Taxpayer never attempted to collect when the notes came due in late 1985 because he knew at that time that the corporation could not pay. The corporation continued to lose money in 1986, 1987 and 1988 and the Taxpayer could not have reasonably expected that the notes had any value during those years. A hope that the advances would be repaid,, without more, is not sufficient. As stated in Levin v. U.S., supra, citing Minneapolis, St. Paul RR v. U.S., 164 Ct.Cl. 226.

> The taxpayer may strike a reasonable course between optimism and pessimism about collection of the debt, but as to when the debt becomes worthless, he must exercise sound business judgment upon as complete information as reasonably available.

Also, no event occurred in 1989 indicating that the debts became worthless in that year and not before. There is no evidence that the departure of the long-time employee substantially affected the economic viability of the business one way or another. There is also no evidence of a drastic or any decline in advertising revenues in 1989. Also, the business reported a profit for the first time in 1989, which indicates that the corporation was better and not less able to pay its debts during that year.

Concerning the retained earnings, the Taxpayer argues that the income has already been taxed and should not be taxed again. However, the income of a corporation is taxed twice, first when it is earned by the corporation and again when the earnings are

distributed as dividends or otherwise to the shareholders. Retained earning have been taxed at the corporate level but are taxable again when disbursed to a shareholder. The retained earnings thus constituted taxable income when disbursed to the Taxpayer's partnership capital account.

The above considered, the Taxpayers properly paid the tax in issue and no refund is due. This Final Order may be appealed pursuant to Code of Ala. 1975, §41-22-20.

Entered on February 24, 1992.

JAMES M. SIZEMORE, JR., Commissioner