

LEE OBSTETRICS & GYNECOLOGY	§	STATE OF ALABAMA
No. 2 Medical Arts Center		DEPARTMENT OF REVENUE
Opelika, AL 36801,	§	ADMINISTRATIVE LAW
DIVISION		
Taxpayer,	§	DOCKET NO. CORP. 01-378
v.	§	
STATE OF ALABAMA	§	
DEPARTMENT OF REVENUE.		

**FINAL ORDER**

The Revenue Department assessed 1996 through 1998 income tax against Lee Obstetrics & Gynecology, P.A. ("Taxpayer"). The Taxpayer appealed to the Administrative Law Division pursuant to Code of Ala. 1975, §40-2A-7(b)(5)a. A hearing was conducted on July 24, 2001. CPA Hal Huguley represented the Taxpayer. Assistant Counsel Jeff Patterson represented the Department.

The issue in this case is whether the Taxpayer should be allowed to carryback a loss from 1998 to 1996.

The Taxpayer filed federal income tax returns on a fiscal year basis for the years ending August 31, 1997, August 31, 1998, and August 31, 1999. The IRS audited the Taxpayer and required it to change to calendar year reporting for the years in issue. The change resulted in additional income being reported in calendar year 1996, and a corresponding increase in deductible expenses in calendar year 1998. The IRS netted the 1996 income and the 1998 expenses, and required the Taxpayer to only pay the accrued interest on the additional 1996 tax.

Based on the IRS adjustments, the Taxpayer filed amended Alabama returns for 1996 and 1997 on a calendar year basis. It also filed an original 1998 Alabama return on a calendar year basis. The amended 1996 return reported

additional income as a result of changing from a fiscal year to a calendar year reporting period. The 1998 return included a corresponding amount of additional deductible expenses, which resulted in a loss in that year. The Taxpayer carried \$220,485 of the 1998 loss back to offset the 1996 gain.

The Department disallowed the carryback because Alabama law allows for only a carryforward of net operating losses. Code of Ala. 1975, §40-18-35.1. The Taxpayer appealed.

The Taxpayer argues that the Department should adopt the IRS position and net the 1998 expenses with the 1996 income. It argues that the offset is allowed by the tax benefit rule.

Alabama's income tax statutes are generally modeled after the federal income tax statutes. However, there are some differences, as illustrated by this case.

Under federal law, a corporation may carry back a loss for either two or three years, depending on when the loss occurred. See generally, 26 U.S.C. §172; Treas. Reg. §1.172-4. However, under Alabama law, a corporation can only carry forward a net operating loss. Code of Ala. 1975, §40-18-35(1). Consequently, the Taxpayer can offset the 1996 income with the 1998 expenses only if the extra-statutory tax benefit rule applies. The tax benefit rule evolved in the federal courts as an equitable method for correcting the transactional disparity that sometimes occurs when events relating to the same item of income or deduction occur in different tax years. The rule treats those events for tax purposes as if they had occurred in the same tax period. The rule provides that the receipt or recovery of an item previously deducted must be reported as income in the year of recovery, although the amount may not technically constitute gross income (rule of inclusion). Conversely, that portion of the recovery which did not result in a tax benefit in the prior year should be

excluded from gross income (rule of exclusion). See generally, *Home Mutual Insurance Co. v. C.I.R.*, 639 F.2d 333 (1980); *First Trust and Savings Bank of Taylorville v. U.S.*, 614 F.2d 1142 (1980).

Congress partially codified the tax benefit rule through 26 U.S.C. §111. That section was amended in 1984 to provide that “gross income does not include income attributable to the recovery during the taxable year of any amount deducted in any prior taxable year to the extent such amount (previously deducted) did not reduce the amount of the tax imposed by this chapter.” In effect, the federal tax benefit rule now applies to all items previously deducted.

The Alabama Supreme Court recognized and adopted the tax benefit rule in *State v. Edelman*, 114 So.2d 261 (Ala. 1959). Citing *Edelman*, the Administrative Law Division also applied the tax benefit rule in *State of Alabama v. Hydro-Mac Food & Vending Services, Inc.*, Inc. 88-179 (Admin. Law Div. 10/22/92).

Unfortunately for the Taxpayer, the tax benefit rule does not apply in this case. The income that resulted in the additional tax due in 1996 did not involve or arise from the same transaction or transactions by which the increased expenses in 1998 were allowed.

Because Alabama law does not authorize a loss carryback, and because the tax benefit rule does not apply, the final assessment must be affirmed. Judgment is entered

against the Taxpayer for \$20,699.00. The Taxpayer still may carry the 1998 loss forward to offset future income pursuant to §40-18-35.1.

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

Entered January 3, 2002.