

STATE OF ALABAMA
DEPARTMENT OF REVENUE,

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STATE OF ALABAMA
DEPARTMENT OF REVENUE
ADMINISTRATIVE LAW DIVISION

§

v.

§

DOCKET NO. INC. 92-147

WILLIAM C. & MYRTLE R. EADY
111 Carol Villa Drive
Montgomery, AL 36109,

§

§

Taxpayers.

§

FINAL ORDER

The Revenue Department denied income tax refunds requested by William C and Myrtle R. Eady (together "Taxpayers") for the years 1988 and 1989. The Taxpayers appealed to the Administrative Law Division and a hearing was conducted on September 29, 1993. William C. Eady (individually "Taxpayer") appeared at the hearing. Assistant counsel Beth Acker represented the Department.

The issue in dispute is whether a \$50,000 stock loss and a \$8,000 bad debt loss incurred by the Taxpayers in 1990 can be carried back as a net operating loss ("NOL") to 1988 and 1989. That issue turns on whether the losses constituted "business" or "nonbusiness" losses for purposes of computing the NOL deduction allowed by Code of Ala. 1975, §40-18-15 (16) . A nonbusiness loss is a loss not incurred in a taxpayer's trade or business and is recognized for NOL purposes only up to the amount of nonbusiness income. See §40-18-15(16)f.3. If the losses in issue are non-business, they cannot be carried back to 1988 and 1989 and the refunds in issue were properly denied.

The Taxpayer, William C. Eady, retired in 1986 after 30 years

in the moving and storage business. The Taxpayer subsequently worked as a manager-trainee for a pest control company at a salary of \$24,000 a year.

The Taxpayer became interested in Southern Maintenance Supply, Inc. ("Southern Maintenance" or "the corporation") in late 1988.

Southern Maintenance had not earned a profit in several years, but the Taxpayer believed that the corporation could be profitable if properly managed. Consequently, the Taxpayer purchased 50% of the corporation's stock in February, 1989 for \$50,000. The Taxpayer thereafter quit his \$24,000 a year job with the pest control company and started working for Southern Maintenance at an annual salary of \$42,000.

The corporation continued losing money and the Taxpayer loaned the business \$8,000 in May, 1989 so it could continue operating.

The corporation filed for bankruptcy and ceased operating in 1990.

The Taxpayers deducted both the \$50,000 stock loss and the \$8,000 bad debt on their 1990 Alabama return. The Department agrees that both losses can be deducted in 1990.

However, the Taxpayers also carried the losses back for refunds to both 1988 and 1989. The Department disallowed the NOL carrybacks and resulting refunds because the Department considers the losses to be nonbusiness in nature, and thus subject to the modification at §40-18-15(16)f.3.

A taxpayer does not engage in a trade or business when he

invests in a corporation, unless the taxpayer is a stockbroker or is otherwise engaged in the business of investing in corporations. Whipple v. Commissioner, 373 U.S. 193, 83 S.Ct. 1168; Betson v. Commissioner, 802 F.2d 365. The Taxpayer's purchase of the Southern Maintenance stock in this case was thus a nonbusiness investment because he was not a stockbroker and was not regularly engaged in the business of investing in stocks.

The Taxpayer argues that he purchased the stock for the business purpose of protecting his \$42,000 a year job with the corporation. I disagree.

An investment or advance to a corporation by a shareholder that is also employed by the corporation may constitute a business transaction, but only if the shareholder/employee, s dominant motive is to protect his job with the corporation, not his investment. U.S. v. Generes, 405 U.S. 93, 92 S.Ct. 827. The Taxpayer could not have purchased the stock of Southern Maintenance to protect his job with the corporation because he purchased the stock before he started working for the corporation. A stockholder must have an existing job, i.e. trade or business, to protect before an advance or loan to the employer corporation can be considered a business transaction.

In Trent v. C.I.R., 291 F.2d 669, a taxpayer was required to purchase \$5,000 worth of stock at the time he accepted employment with a corporation. He then made numerous loans to the corporation

for the purpose of protecting his job. The resulting losses from the bad loans were allowed as business losses, but the initial \$5,000 stock purchase was treated as a nonbusiness investment. Trent illustrates that an investment in a corporation made prior to or concurrent with an investor obtaining a job with the corporation is a nonbusiness investment, whereas later advances by the investor/employee for the purpose of saving or protecting his existing job may be treated as a business transaction.

The \$8,000 loan by the Taxpayer to the corporation in May, 1989 also must be treated as a nonbusiness debt. "It is settled that loans by a controlling shareholder to his closely held corporation generally give rise to nonbusiness debts." Kelly v. Patterson, 331 F.2d 753, at page 755.

The \$8,000 loan by the Taxpayer obviously served a dual purpose. It both protected the Taxpayer's initial \$50,000 stock investment in the corporation, and by doing so it also protected his job with the corporation. However, the Taxpayer has failed to prove that the loan was dominantly motivated to preserve his job and not protect his initial \$50,000 at-risk investment. Consequently, the \$8,000 loan cannot be considered a business transaction under the reasoning of Generes, supra.

The \$50,000 stock loss and the \$8,000 bad debt loss were properly treated by the Department as nonbusiness losses for NOL purposes. Accordingly, the 1988 and 1989 refunds in issue were

properly denied.

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

Entered on April 21, 1994.

BILL THOMPSON
Chief Administrative Law Judge