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| STATE OF ALABAMA,<br>DEPARTMENT OF REVENUE,<br><br>vs.<br><br>JOHN A. MARKS<br>P. O. Box 131468<br>Birmingham, AL 35213,<br><br>Taxpayer. | §<br><br>§<br><br>§<br><br>§<br><br>§<br><br>§ | STATE OF ALABAMA<br>DEPARTMENT OF REVENUE<br>ADMINISTRATIVE LAW DIVISION<br><br>DOCKET NO. INC. 93-145 |

FINAL ORDER

The Revenue Department assessed 1989 income tax against John A. Marks ("Taxpayer"). The Taxpayer appealed to the Administrative Law Division and a hearing was conducted on June 16, 1993. Delphine E. Ford and Steve Jones represented the Taxpayer. Assistant counsel Beth Acker represented the Department.

The primary issue in this case is whether the Taxpayer should be allowed to deduct losses of $575,000 and $621,922 claimed on his 1989 Alabama return. If the losses can be deducted, a second issue is in what year can the losses be claimed.

The Taxpayer was the sole shareholder in American Sofa, Inc. ("American Sofa"), and was also a major stockholder in Marks-Fitzgerald Furniture Company, Inc. ("Marks-Fitzgerald") during the period in issue.

American Sofa was having severe financial problems and the Taxpayer personally loaned the company $575,000 in 1988. This loan is undisputed by the Department.

American Sofa filed a petition in bankruptcy in April, 1989. The business continued operating, but because it was insolvent, Marks-Fitzgerald paid the business's operating expenses during 1989 totaling $621,933.[1] That amount was shown as a loan from Marks-Fitzgerald to American Sofa on the books of both corporations. The Taxpayer, although not legally obligated to do so, personally satisfied the loan on behalf of American Sofa in late 1989 by transferring property to Marks-Fitzgerald equal in value to the amount of the loan.

American Sofa continued operating, but reported sales of only $8,846 in 1990 and $0 in 1991. The business closed in 1991.

American Sofa repaid the Taxpayer $55,000 in 1990 and $2,223 in 1991. The Taxpayer failed to report those amounts on his 1990 or 1991 returns, but now concedes that those amounts should have been reported and were only inadvertently omitted.

The Taxpayer claimed the $575,000 and the $621,922 as losses on his individual 1989 Alabama return. The Department concedes that the $575,000 can be deducted, but only in 1991, not in 1989. The Department also argues that the $621,922 cannot be deducted at all because the Taxpayer was not personally obligated to repay the loan from Marks-Fitzgerald to American Sofa.

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[1] Because American Sofa could not get credit from its suppliers, Marks-Fitzgerald used its credit to buy furniture for American Sofa in 1989. This is how the loan from Marks-Fitzgerald to American Sofa occurred.

Issue I. Can the $575,000 and/or the $621,933 be deducted by the Taxpayer.

First, I agree with the Department that the $575,000 loan to American Sofa can be deducted by the Taxpayer as a non-business bad debt.

A loan by a shareholder to a corporation must be treated as a non-business debt. Kelly v. Patterson, 331 F.2d 753. The debt, if it later becomes worthless, can then be deducted in the year that it becomes worthless as a non-business loss incurred in a transaction entered into for profit pursuant to Code of Ala. 1975, §40-18-15(5). For a discussion of when the $575,000 became worthless, see Issue II below.

Can the Taxpayer deduct the $621,933 that he personally paid to satisfy the loan from Marks-Fitzgerald to American Sofa?

For tax purposes, a corporation and its shareholders must be treated as separate entities. "The trade or business of a corporation is not that of its shareholders". Betson v. C.I.R., 802 F.2d 365, citing Whipple v. Commissioner, 373 U.S. 193, 83 S.Ct. 1168. Consequently, the $621,922 paid by the Taxpayer on behalf of American Sofa was not incurred in the Taxpayer's trade or business, and thus cannot be deducted as an ordinary and necessary business expense under Code of Ala. 1975, §40-18-15(1).

The Taxpayer also did not loan the $621,922 to American Sofa, and thus the amount cannot be deducted as a bad debt as was the

$575,000. However, the payment should be treated as a contribution to capital by the Taxpayer to American Sofa in 1989, thereby increasing the Taxpayer's basis in American Sofa at that time.

A voluntary contribution by a shareholder to a corporation for any purpose constitutes a contribution to capital. Betson v. C.I.R., supra, at page 368, see also, IRC Reg. Section 1.263(a)-2(f). The Taxpayer's voluntary payment of American Sofa's debt to Marks-Fitzgerald in substance constituted a voluntary contribution of capital by the Taxpayer to American Sofa in 1989. The fact that the Taxpayer was not legally obligated to pay the loan or that he paid Marks-Fitzgerald directly should not prevent him from realizing an increased basis in American Sofa. Substance over form should govern.

Issue II. In what year can the $575,000 and the $621,933 be deducted.

A bad debt or stock loss must be deducted in the year that the debt or stock becomes worthless. In determining when a debt or stock becomes worthless, the financial condition of the debtor or the subject corporation is of primary importance. K and R Service Company, Inc. v. U.S., 568 F.Supp. 38; Roth Steel Tube Company v. C.I.R., 620 F.2d 1176. The test is whether a reasonable businessman exercising prudent business judgment would consider the debt or stock to be worthless. Levin v. U.S., 597 F.2d 760.

Bankruptcy is evidence of worthlessness, as is insolvency, but those facts are not conclusive if the debtor corporation continues to operate as a viable business. Roth Steel Tube Company v. C.I.R., supra, at page 1182.

The Department argues that the loan to (and stock of) American Sofa did not become worthless until 1991 because the business continued operating until that year. The Department also points out that American Sofa repaid the Taxpayer $55,000 in 1990 and $2,223 in 1991. However, the worthlessness of a debt or stock must be decided from the facts as they exist at the end of the year of asserted worthlessness. Estate of Mann, 731 F.2d 267. The fact that some of the debt is later repaid does not preclude a taxpayer from claiming the loss in a prior year. Estate of Mann, supra, at page 278.

In my opinion, the debts and stock of American Sofa were worthless at the end of 1989. The corporation had filed for bankruptcy and was unable to pay its operating expenses in that year. The Taxpayer recognized that American Sofa would not be able to repay Marks-Fitzgerald, and thus personally repaid the loan in 1989. The corporation continued to operate, but had only negligible sales in 1990 and no sales in 1991. A reasonable person would have considered the debts and stock of American Sofa to be worthless on December 31, 1989.

The above considered, the Taxpayer should be allowed to deduct both the $575,000 loan as a non-business bad debt and the $621,933 contribution to capital as a nonbusiness loss in 1989. Accordingly, the assessment in issue is dismissed. The Taxpayer does owe additional tax on the $55,000 and the $2,223 received from American Sofa in 1990 and 1991, respectively.

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 13, 1994.

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BILL THOMPSON
Chief Administrative Law Judge