STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	STATE OF ALABAMA DEPARTMENT OF REVENUE
vs.	§	
COOPER L. AND ORA MAE FRAZIER P. O. Box 67 Belle Mina, AL 35615-0067	§	DOCKET NO. INC. 94-195
Taxpayers.	§	

FINAL ORDER

The Revenue Department assessed income tax against Cooper L. and Ora Mae Frazier (together "Taxpayers") for the year 1991. The Taxpayers appealed to the Administrative Law Division and a hearing was conducted on September 27, 1994. J. Birch Bowdre represented the Taxpayers. Assistant counsel Beth Acker represented the Department.

Ora Mae Frazier (individually "Taxpayer") sold land to a family partnership in 1981. The parties entered into a ten year installment note whereby the Taxpayer was to receive semi-annual installments from the partnership and then a balloon payment at the end of the ten years. A month before the balloon payment was due, the Taxpayer and the partnership executed a "renewal note" for another ten year period under the same terms as the original note. The issue in this case is whether the principal balance due on the original note was "constructively received" by the Taxpayer in 1991. If so, the Taxpayer must recognize gain on the principal as taxable income in 1991.

The facts are undisputed.

On June 20, 1981, the Taxpayer sold 1,120 acres of real estate

for $669,000 to Frazier Farms, a partnership comprised of the Taxpayer, her husband, and her son, Samuel L. Frazier.

The Taxpayer and the partnership executed a purchase money mortgage whereby the partnership agreed to make semi-annual installments over a 10 year period, with the lump sum balance due at the end of the ten year period, or on June 30, 1991. The Taxpayers reported the interest portion of each installment as interest income on their Alabama returns in the year received. The gain portion of the principal was also reported as taxable income.

In early 1991, the Taxpayer and her CPA discussed her options concerning the upcoming balloon payment due on June 30, 1991. The Taxpayer had primarily invested in short term (6 month or 1 year) certificates of deposit and money market funds. She knew that those funds were paying less than 6% in 1991, although some longer term investments were paying more than 6%.

The Taxpayer also knew that the partnership had only approximately $320,000 in cash on hand in 1991, not enough to pay the approximately $607,000 owed on the note. Considering the above, the Taxpayer and the partnership executed a renewal note on June 1, 1991. The note was for the outstanding balance on the original note of ($607,450.29), and included the same 6% interest rate and the same 10 year payment terms as the original note. For tax purposes, the Taxpayers continued to report the semi-annual installment payments on the renewal note the same as the payments

had been reported on the original note.

The Department audited the Taxpayers and determined that the Taxpayer had constructively received the principal balance due of $607,450.29 in 1991. Based thereon, the Department treated the gain portion of the principal (approximately $501,000) as taxable income to the Taxpayers in 1991.

There are no Alabama cases on the issue of constructive receipt of income. The constructive receipt rule holds that actual receipt of income is not necessary for the income to be taxable. Rather, a taxpayer must treat income as received (and thus taxable) in the year in which the income is available and the taxpayer has the ability to obtain or use the income without restriction. See, U. S. v. Hancock Bank, 400 F.2d 975 (5th Cir. 1968); Treas. Reg. §1.451-2.

I can find no case law or other authority which holds that the extension or renewal of loan or installment obligation prior to the final due date of the loan or obligation constitutes constructive receipt of the amount that would have been received under the original obligation.

The Department cites Rhombar Company v. Commissioner, 47 T.C. 75 (1966) aff'd. on other grounds, 386 F.2d 510 (1967) in support of its position. In Rhombar, various family members controlled a corporation, Rhombar, which held the promissory notes of another

family controlled corporation. The family members agreed to extend the due date of the promissory notes beyond the original due date. The IRS attempted to tax that amount that would have been received under the original notes as having been constructively received. The Tax Court rejected the IRS's argument, as follows :

> The respondent contends that the amount of $67,500, representing the amount of due but unpaid installment obligations owing to the petitioner from John Stuart Inc., which the petitioner omitted from gross income, should properly have been reported as gross income for that year. It is his position that the amounts of such notes were constructively received in that year, citing section 1.451-2 of the Income Tax Regulations. He argues, in effect, that John Stuart Inc. was able to pay the notes upon the maturity dates but that members of the Rothschild family, who controlled both the petitioner and John Stuart Inc., chose not to demand payment because they preferred that John Stuart Inc. should use its funds otherwise.
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> Section 44 of the Internal Revenue Code of 1939 provides that in the case of a sale on the installment plan there may be returned as income in any taxable year that proportion of the installment payments actually received in the taxable year which the gross profit realized or to be received bears to the total contract price.
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> While we agree with the respondent that the circumstances here presented warrant special scrutiny to determine whether the petitioner constructively received the payments, it is our conclusion, after careful examination of the record, that it should not be considered that the amount of such notes was constructively received. We think that the nonpayment of the notes was based upon a valid business reason from the standpoint of both the obligor and the obligee. Despite the fact that the Rothschilds may have controlled both corporations, it appears that the corporations dealt with each other, at least insofar as these notes were concerned, on an arms-length basis. The evidence shows that failure to pay the notes when due was attributable to the stringent cash position of John Stuart Inc. A plan was worked out, pursuant to the recommendation of the minority stock

> interest of John Stuart Inc., whereby the long-term debt owed to the petitioner, including the payments in arrears, was re-funded over an extended period. The petitioner, in consideration of its agreement to extend the time for payment, was to be paid interest upon the unpaid amounts, whereas under the old agreement no interest was payable. And it may be added that it does not appear that deferral of payment of the notes was prompted by a tax-avoidance motive on the part of the petitioner.

The facts in Rhombar are sufficiently similar to be controlling in this case. As in Rhombar, the involvement of family members is not fatal. The Taxpayer testified that she agreed to renew the note for valid business reasons. First, the renewal note gave her a steady 6% return on her money. Second, the partnership did not have sufficient money to pay the entire balance due.

I question the Taxpayer's argument that the 6% rate was the best she could get in 1991. Long-term CDs were paying 6% and higher in 1991, and clearly a 10 year note is long-term. (R. 34). But the 6% rate was at least reasonable.

I do agree, however, that the partnership's lack of sufficient assets to pay the balloon note clearly did constitute a valid business reason. The partnership could have borrowed the additional money needed to make the balloon payment, but a valid business decision was made to renew the note instead.

If the parties had not executed the renewal note and the partnership had defaulted on the balloon note, clearly the Taxpayer would not have been required to recognize the unpaid principal as income. The Taxpayer should not be penalized because the parties

anticipated that the partnership would be unable to pay.

The above considered, the final assessment in issue is dismissed. 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 26, 1995.

BILL THOMPSON
Chief Administrative Law Judge