NANCY G. SMITH 212 Vondale Drive Birmingham, Alabama 35215,	§	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayer,	§	DOCKET NO. INC. 95-346
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

FINAL ORDER

The Revenue Department denied refunds of income tax requested by Nancy G. Smith ("Taxpayer") for the years 1986 through 1993. The Taxpayer appealed to the Administrative Law Division, and a hearing was conducted on November 13, 1995. CPA Russell R. Rhodes represented the Taxpayer. Assistant Counsel Jeff Patterson represented the Department.

The issue in this case is whether a loss incurred by the Taxpayer in 1989 can be carried back and over to other years as a net operating loss ("NOL"). That issue turns on whether the 1989 loss was a "business" loss or a "nonbusiness" loss for purposes of the NOL deduction at Code of Ala. 1975, §40-18-15(16). Nonbusiness losses are allowed for NOL purposes only up to the amount of the taxpayer's nonbusiness income in the subject year. See, §40-18-15(16)f.3. Consequently, if the loss in issue is nonbusiness, it cannot be carried back or over as a NOL to any other years, and the refunds in issue must be denied.

The Taxpayer was sole shareholder in Teddy's Yogurt Factory, Inc. ("Teddy's Yogurt"). Teddy's Yogurt was incorporated in 1985, and began operating a retail yogurt shop in Birmingham in 1986.

The Taxpayer operated the business, but never received a salary because the business was never profitable.

The Taxpayer initially invested $1,000.00 in the corporation. She thereafter loaned the corporation approximately $107,000.00 from 1985 until 1989. That money was used to keep the business operating.

The business closed in 1989 and the Taxpayer failed to recover any of the $107,000.00. She did not initially claim a loss on her original 1989 individual Alabama return. Rather, she reported and paid tax due of $588.00. However, she subsequently claimed the $107,000.00 as a loss on an amended 1989 return. The Department concedes that the loss should be allowed in full in 1989, and that the $588.00 previously paid by the Taxpayer should be refunded.

The Taxpayer also filed amended returns and carried the 1989 loss back to 1986, 1987, and 1988 and forward to 1990, 1991, 1992, and 1993. The Department rejected the amended returns and the refunds claimed thereon based on its position that the 1989 loss was nonbusiness, and thus subject to the §40-18-15(16)f.3. modification.

A loss is a business loss if it is incurred in a taxpayer's regular trade or business. An employee's job with a corporation is the employee's trade or business. Consequently, if an employee makes loans or advances to the corporation primarily to protect or insure his job, the loans or advances are business in nature.

On the other hand, if the employee also owns stock in the

corporation, any loans or advances to the corporation will be considered non-business if the shareholder's primary purpose in making the loans or advances is to protect his investment, and not to protect his job.

In Kelly v. Patterson, 331 F.2d 753 (1964), the taxpayer owned 98 percent of the stock of a corporation and also worked for the corporation. The taxpayer received a total salary of approximately $30,000.00 from 1958 through 1960, but also loaned the corporation over $66,000.00 to allow the corporation to continue operating during those years. The corporation became insolvent in 1960, and the taxpayer attempted to deduct the loans as business losses. The Fifth Circuit rejected the taxpayer's argument and held that the losses were non-business, as follows:

> The District Court ruled that the loans constituted nonbusiness bad debts within the meaning of the statute. We agree. The burden was on the taxpayer to show that he was entitled to the claimed deductions, i.e., that he was engaged in a trade or business, and that the debt in question was incurred in connection with that trade or business. His business is to be distinguished from that of the corporation, and the debt must bear a proximate relationship to his trade or business. See United States v. Byck, 5 Cir., 1963, 325 F.2d 551.
>
> It is settled that loans by a controlling shareholder to his closely held corporation generally give rise to nonbusiness debts. This is because an investor is not engaged in a trade or business. An exception is where the shareholder can establish his business as being that of promoting, managing and financing corporations. No such claim was made here. See Whipple v. Commissioner, 5 Cir., 1962, 301 F.2d 108, vacated and remanded on another ground, 1963, 3737 U.S. 193, 83 S.Ct. 1168, 10 L.Ed.2d 288; and Byck, supra, where the exception was recognized but held not established. The Supreme Court makes it clear in its decision in Whipple that a bad debt

> loss sustained by an investor furnishing management to a corporation is not one sustained in, or in connection with a trade or business. And the following cautionary language is from that opinion:
>
> > Even if the taxpayer demonstrates an independent trade or business of his own, care must be taken to distinguish bad debt losses arising from his own business and those actually arising from activities peculiar to an investor concerned with, and participating in, the conduct of the corporate business.

Kelly v. Patterson, at page 755.

The rationale of Kelly v. Patterson was followed by the Administrative Law Division in State v. Marks, Admin. Law Docket Inc. 93-145, decided April 13, 1994, and State v. Eady, Admin. Law Docket Inc. 92-147, decided April 21, 1994. Those cases are also controlling in this case.

The Taxpayer owned and was also employed by Teddy's Yogurt, Inc. However, she did not draw a salary from the business. Certainly, the Taxpayer did not loan the corporation $107,000.00 primarily to protect a job for which she never drew a salary. Rather, her primary motive was to keep the corporation in business.

The Taxpayer argues that a sole proprietorship or partnership would be allowed a business loss under the same circumstances. That may be correct, but the Taxpayer elected to operate through the corporate form, and she must now abide by the consequences of that decision. For tax purposes, a corporation and its shareholders must be treated as separate entities. Betson v. CIR, 802 F.2d 365 (9th Cir. 1986).

> As a general rule, the trade or business of a corporation is not that of its shareholders. *See Whipple v. Commissioner*, 373 U.S. 193, 202, 83 S.Ct. 1168, 1174, 10 L.Ed.2d 288 (1963). Shareholders, unless they are traders, do not engage in a trade or business when they invest in the stock of a corporation. *Id.* Consequently, shareholders are generally not permitted to deduct under section 162(a) sums advanced to a corporation to meet its expenses or pay its debts. *See, e.g., Grauman v. Commissioner*, 357 F.2d 504, 505-06 (9th Cir. 1966); 7 Mertens, *Law of Federal Income Taxation* §38.22, at 50 (1985).
>
> * * *
>
> These rules are consistent with the principle that if a taxpayer chooses to conduct business through a corporation, he will not subsequently be permitted to deny the existence of the corporation if it suits him for tax purposes. *See, e.g., Moline Properties, Inc. v. Commissioner*, 319 U.S. 436, 438-39, 63 S.Ct. 1132, 1133-34, 87 L.Ed. 1499 (1943) (individuals adopting corporate form must accept tax disadvantages); *O'Neill v. Commissioner*, 271 F.2d 44, 49 (9th Cir. 1959) (declining to ignore corporate entity). In particular corporate shareholders will not be permitted to claim deductions for ordinary and necessary expenses incurred by the corporation even though paid by the shareholders. (Cites omitted).
>
> There are exceptions to these principles. If Betson paid corporate expenses in the ordinary and necessary course of some trade or business *of his own*, a deduction would be permitted. *See, e.g., Madden v. Commissioner*, 40 T.C.M. (CCH) 1103, 111 (1980); *Lohrke v. Commissioner*, 48 T.C. 679, 688-89 (1967); *cf. O'Neill*, 271 F.2d at 48 (considering loss deduction). Payments made, however, with the purpose of keeping in business a corporation in which the taxpayer holds an interest are not deductible. *Madden*, 40 T.C.M. at 1111. *Cf. Dodd*, 298 F.2d at 576-77 (deduction disallowed where expenses of corporation are only "incidentally related" to taxpayer's own trade or business).

Betson v. CIR, at pages 368, 369.

The loans by the Taxpayer in this case to keep her corporation

operating were not business loans because the Taxpayer was not regularly engaged in the business of loaning money to corporations. She made the loans to keep the corporation operating, not primarily to save her job with the corporation. Consequently, the loss must be treated as nonbusiness, and thus cannot be considered in computing an NOL carryover deduction to other years. The refunds in issue are accordingly denied.

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

Entered January 10, 1996.

BILL THOMPSON
Chief Administrative Law Judge