

JACK AND MERLE W. WATSON §
c/o Doug Hill, CPA
Cork, Hill & Company, LLC §
2100 Southbridge Parkway, Suite 530
Birmingham, AL 35209, §

STATE OF ALABAMA
DEPARTMENT OF REVENUE
ADMINISTRATIVE LAW DIVISION

Taxpayers, §

DOCKET NO. INC. 02-154

v. §

STATE OF ALABAMA §
DEPARTMENT OF REVENUE

FINAL ORDER

The Revenue Department assessed Jack and Merle W. Watson (together “Taxpayers”) for income tax for 1996 through 1999. The Taxpayers appealed to the Administrative Law Division pursuant to Code of Ala. 1975, §40-2A-7(b)(5)a. A hearing was conducted on June 27, 2002. Jack Watson (individually “Taxpayer”) and CPA Doug Hill represented the Taxpayers. Assistant Counsel Jeff Patterson represented the Department.

The issue in this case is whether the Taxpayers should be allowed to carryover a 1995 net operating loss (“NOL”) as a deduction to their 1996 through 1999 Alabama returns.

The Taxpayer was the sole owner of Tamrak Industries from 1984 until the business closed in December 1996. Tamrak manufactured baker’s racks used as display fixtures in gift shops, retail stores, etc.

Tamrak began suffering financial problems in the early 1990’s. Consequently, the Taxpayers began loaning or advancing money to pay the business’s operating expenses. The money came primarily from savings and Mrs. Watson’s job as a school teacher.

The Taxpayers loaned or advanced the business \$43,092 from 1994 through 1996. The business finally closed in December 1996. The Taxpayers subsequently claimed a \$30,000 business-related bad debt on their individual 1997 Alabama return. That loss was allowed.

The Taxpayers also claimed NOL carryovers from 1995 on their 1996 through 1999 Alabama returns. The amounts claimed were \$16,962 in 1996, \$8,520 in 1997, \$45,961 in 1998, and \$19,559 in 1999. The 1995 loss that generated the NOL carryovers was presumably related to Tamrak industries.

The Department audited the Taxpayers and disallowed the NOL carryovers because there was no evidence that the 1995 NOL was incurred in the Taxpayers' trade or business. As discussed below, only losses incurred in a taxpayer's trade or business may be used in computing an NOL carryover. Code of Ala. 1975, §40-18-15.2(5)c.¹

The primary issue was initially thought to be whether the loss claimed by the Taxpayers on their 1997 return should be allowed. As indicated, however, that loss was allowed. Rather, the dispute concerns whether the 1995 loss, which totaled \$176,886, constituted a business loss that could be carried over to the subject years.

At the June 27 hearing, the parties were directed to investigate and notify the Administrative Law Division of the nature of the 1995 loss. The Department was also directed to explain why the 1995 loss could not be carried over to later years.

The Taxpayers' representative responded that he was unable to determine the

¹Section 40-18-15.2(5)c. applies for tax years beginning after December 31, 1997. For prior tax periods, the identical provision was found at Code of Ala. 1975, §40-18-

nature of the 1995 loss, other than it related to Tamrak Industries. The Department responded that it also assumed that the loss related to Tamrak, but that the loss could not be allowed as an NOL because the loans or advances by the Taxpayers to the corporation that resulted in the loss were not business losses. Specifically, the Department claims that the loans or advances were made by the Taxpayers to keep the business operating, and not to protect Mr. Watson's job as an employee of the business.

Nonbusiness losses are allowed for NOL purposes only up to the amount of nonbusiness income received in the year. Section 40-18-15(5)c. A loss is a business loss if it is incurred in a taxpayer's regular trade or business. An employee's job is the employee's trade or business. Consequently, if an employee makes loans to his corporate employer primarily to protect his job, the loans are business in nature, and thus can be considered in computing an NOL carryover. However, if the employee also owns or is a stockholder in the corporation, any loans or advances will be considered nonbusiness if the employee/owner's primary purpose in making the loans or advances was to protect his investment, and not to protect his job. *Betson v. C.I.R.*, 802 F.2d 365 (9th Cir. 1986); *Kelly v. Patterson*, 331 F.2d 753 (5th Cir. 1964).

In this case, the Taxpayer owned and also worked at Tamrak Industries. However, he never received a salary from the business. The Taxpayers advanced money to the business to keep it running, not to protect the Taxpayer's income from his job with the business. Consequently, even if the 1995 losses were substantiated, those losses could not be carried over as an NOL to the years in question. See generally, *Smith v. State of Alabama, Inc.* 95-346 (Admin. Law Div. 1/10/96) ("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.”). See also, *Brady v. State of Alabama, Inc.* 97-426 (Admin. Law Div. 5/14/98); *State v. Eady, Inc.* 92-147 (Admin. Law Div. 4/21/94); *State v. Marks, Inc.* 93-195 (Admin. Law Div. 4/13/94).

The final assessments are affirmed. Judgment is entered against the Taxpayers for 1996 tax, penalty, and interest of \$1,235.35; 1997 tax, penalty, and interest of \$2,836.89; 1998 tax, penalty, and interest of \$2,652.49; and 1999 tax, penalty, and interest of \$899.09. Additional interest is also due from the date of entry of the final assessments, January 11, 2002.

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

Entered May 9, 2003.