

M.D. LOWE
5328 Gunn Road
Mobile, Alabama 36619,

Taxpayer,

v.

STATE OF ALABAMA
DEPARTMENT OF REVENUE
ADMINISTRATIVE LAW DIVISION

DOCKET NO. INC. 96-368

STATE OF ALABAMA
DEPARTMENT OF REVENUE.

OPINION AND PRELIMINARY ORDER

The Revenue Department assessed income tax against M.D. Lowe ("Taxpayer") for 1992 and 1993. The Taxpayer appealed to the Administrative Law Division pursuant to Code of Ala. 1975, ' 40-2A-7(b)(5)a. A hearing was conducted on March 27, 1997 in Mobile, Alabama. CPA Thomas A. George represented the Taxpayer. Assistant Counsel Duncan Crow represented the Department.

This case involves the net operating loss ("NOL") deduction allowed at Code of Ala. 1975, ' 40-18-15(16). The specific issue is whether the Taxpayer should be allowed to carryover a loss from 1986 to the years in issue, 1992 and 1993. That issue turns on whether the 1986 loss was a business or nonbusiness loss. Business losses are allowed in full in computing a NOL, but nonbusiness losses are allowed only to offset nonbusiness income. Code of Ala. 1975, ' 40-18-15(a)(16)f.3.

The Taxpayer incurred a loss in 1986. The Taxpayer initially claimed, and the Department apparently agreed, that the loss was reported as a ' 1244 stock loss on his 1986 return. Unfortunately, the 1986 return was not offered into evidence at the March 27 hearing. The Taxpayer subsequently carried the 1986 loss over as an NOL on his 1992

and 1993 returns.

26 U.S.C. ' 1244 governs losses on small business stock for federal income tax purposes. Section 1244(b) designates that the first \$100,000 of such loss shall be deemed an ordinary (business) loss for federal purposes, with anything over \$100,000 treated as a capital (nonbusiness) loss.

The Department applied ' 1244(b), and thus allowed the Taxpayer to carryover the first \$100,000 of the 1986 loss as a business loss to 1992 and 1993. However, the Department applied the ' 40-18-15(a)(16)f.3. limitation, and thus disallowed the NOL in excess of \$100,000 by treating it as a nonbusiness loss.

The Taxpayer argues that the federal ' 1244(b) distinction between ordinary business losses and capital or nonbusiness losses is not applicable under Alabama law. The Taxpayer cites Department Reg. 810-3-15-.22(1)(b)1.(i), which defines "business" for NOL purposes to include "Schedule D losses on IRC ' 1244 stock." I agree with the Taxpayer.

Alabama has no statute similar to IRC ' 1244. Rather, Department Reg. 810-3-15-.22 defines a ' 1244 stock loss as a business loss. Such loss should be allowed in full for Alabama NOL purposes, without regard to the \$100,000 limitation imposed for federal purposes.

Unfortunately for the Taxpayer, however, the evidence indicates that the 1986 loss was not a ' 1244 stock loss as first claimed by the Taxpayer. Rather, the Taxpayer's

representative stated at the March 27 hearing that the loss related to personal loans made by the Taxpayer to his corporation. The loans became uncollectible when the corporation failed in 1986.

Arm's-length loans by a shareholder to a corporation are nonbusiness transactions for NOL purposes, even if the shareholder owned and operated the business. See generally, Bedsole v. State, Inc. 94-410 (Admin. Law Div. 11/13/95) and Nancy G. Smith v. State, Inc. 95-346 (Admin. Law Div. 1/10/96), and federal cases cited therein, Kelly v. Patterson, 331 F.2d 753 (1964), Betson v. C.I.R., 802 F.2d 365 (9th Cir. 1986), and Whipple v. C.I.R., 87 S.Ct. 1168 (1963).

The Taxpayer argues that the Department never questioned that the loss was a '1244 stock loss before the March 27 administrative hearing. But if the 1986 loss involved uncollectible personal loans and not a '1244 stock loss, the correct nonbusiness nature of the loss must be recognized.

The burden is on a taxpayer to prove his right to a claimed deduction. U.S. v. Wodtke, 627 F.Supp. 1034 (1985). The Taxpayer is allowed until June 6, 1997 to provide information reasonably establishing that the 1986 loss was a '1244 stock loss. The information should be provided to Assistant Counsel Duncan Crow in Mobile. The Department should review the information and notify the Administrative Law Division of its position. Appropriate action will then be taken.

This Opinion and Preliminary Order is not an appealable Order. The Final Order, when entered, may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, '40-2A-9(g).

Entered May 9, 1997.

BILL THOMPSON
Chief Administrative Law Judge

BT:dr

cc: Duncan R. Crow, Esq.
Thomas A. George, CPA
Kim Herman