

LINDA H. DUPREE
3706 Preserve Bay Boulevard
Panama City, FL 32408-7136,

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STATE OF ALABAMA
DEPARTMENT OF REVENUE
ADMINISTRATIVE LAW DIVISION

Taxpayer,

§

DOCKET NO. INC. 97-293

v.

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STATE OF ALABAMA
DEPARTMENT OF REVENUE.

§

FINAL ORDER

The Revenue Department denied income tax refunds requested by Linda H. Dupree ("Taxpayer") for 1991 and 1992. The Department also assessed the Taxpayer for 1994 income tax. The Taxpayer appealed the final assessment pursuant to Code of Ala. 1975, §40-2A-7(b)(5)a., and the denied refunds pursuant to Code of Ala. 1975, §40-2A-7(c)(5)a. The matter was submitted by the parties on a joint stipulation of facts. David Johnston represented the Taxpayer. Assistant Counsel Gwen Garner represented the Department.

The Taxpayer paid \$857,500 in 1993 to settle a lawsuit relating to her activities as an officer and director of Graceba Total Communications, Inc. ("corporation"). The settlement resulted in a net loss in 1993, which the Taxpayer carried back as a business-related net operating loss ("NOL") to 1991 and 1992, and over to 1994. The Department denied the NOL, and instead allowed the settlement amount as a miscellaneous non-business itemized deduction in 1993.

The issue is whether the 1993 loss was "business" or "non-business" related. Business deductions are allowed in full in computing an NOL. Non-business deductions are allowed only to offset non-business income. Code of Ala. 1975, §40-18-15(16)f.3.

Consequently, the NOLs in issue can be allowed only if the 1993 loss was attributable to the Taxpayer's trade or business.

The Taxpayer and her husband, Cecil Dupree, were officers, directors and major shareholders of the corporation during the years in issue.

In 1991, Jimmy B. Dupree, Cecil Dupree's younger brother, sued Cecil Dupree and various unnamed corporate officers and directors of the corporation (together "Defendants"). The complaint alleged that the Defendants, as officers and directors of the corporation, had breached their fiduciary duty to the corporation, to Jimmy Dupree, individually, as a minority shareholder in the corporation, and Jimmy Dupree, as beneficiary of the Cecil B. Dupree Trust. The sole asset of the Trust was stock in the corporation. The complaint specifically alleged that the Defendants had wasted the assets of the corporation, and had siphoned funds from the corporation for their personal benefit and to avoid paying dividends to Jimmy Dupree.

The parties filed various Answers, Motions, Counterclaims and Amended Complaints. The Taxpayer initially was not a named defendant, but was added as a named defendant in a Second Amended Complaint.

The amended complaint alleged, among other things, that the Taxpayer and her husband, as officers and directors of the corporation, had misappropriated and diverted corporate funds and opportunities, siphoned funds from the corporation for personal use, used their position as officers of the corporation to profit personally to the detriment of Jimmy Dupree, and had rented their own property to the corporation at exorbitant rates.

The parties settled the lawsuit in 1993. The settlement provided in part that the Taxpayer and her husband would pay Jimmy Dupree \$1,750,000 for alleged non-economic losses on or before June 25, 1993. The Taxpayer paid \$857,500 of that amount. Her husband paid the balance.

The Taxpayer claimed the \$857,500 as a loss on her 1993 Alabama return, which reduced her taxable income to \$0 in that year. She also carried the remainder of the loss as an NOL deduction to 1991, 1992, and 1994. The Department recharacterized the loss as a non-business itemized deduction allowable in 1993 only, and accordingly denied the NOL carrybacks to 1991 and 1992, and the carryover to 1994. The Taxpayer appealed to the Administrative Law Division.

For NOL purposes, a non-business deduction is allowed only to offset non-business income. §40-18-15(16)f.3. Consequently, if the amount paid by the Taxpayer to settle the lawsuit in 1993 was not attributable to her trade or business, it cannot be allowed in computing an NOL.

Whether amounts incurred in or paid to settle a lawsuit are business or personal in nature is determined under the court-created "origin of the claim" test. This test was first explained by the United States Supreme Court in U.S. v. Gilmore, 83 S.Ct. 623 (1963).

In Gilmore, the taxpayer attempted to deduct legal expenses incurred in a divorce action. The taxpayer argued that the expenses could be deducted as business expenses because they were to protect and preserve his business interests in three automobile dealerships. The Supreme Court rejected the taxpayer's claim, holding that the origin of the expenses, the divorce action, was personal in nature.

"The principle we derive from these cases is that the characterization, as 'business' or 'personal,' of the litigations cost of resisting a claim depends on whether or not the claim *arises in connection with* the taxpayer's profit-seeking activities. It does not depend on the *consequences* that might result to a taxpayer's income-producing property from a failure to defeat the claim,..."(emphasis in original)

"For these reasons, we resolve the conflict...in favor of the view that the origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences upon the fortunes of the taxpayer, is the controlling basic test of whether the expense was 'business' or 'personal' and hence whether it is deductible or not..."

The rationale of Gilmore has been cited and affirmed in numerous cases. See generally, Keller Street Development Co. v. CIR, 688 F.2d 675 (1982), and cases cited therein.

In this case, the Taxpayer was an officer and director of the corporation. "A director of a corporation is engaged in the business of performing those duties that devolve to him as a director of the corporation (cites omitted)...These duties include being entrusted with the management of the affairs of the corporation while exercising diligence in managing and preserving the corporation's assets." Steffens v. Commissioner of IRS, 707 F.2d 478, 483 (1983). See also, Noland v. CIR, 269 F.2d 108 (1959), and Commissioner of Internal Revenue v. Peoples-Pittsburgh Trust Co., 60 F.2d 187 (1932). The Taxpayer thus was engaged in a trade of business while performing her duties as an officer and director of the corporation.

The origin of the lawsuit against the Taxpayer was her alleged misconduct in her capacity as a director and officer of the corporation. The settlement payment was thus

attributable to the Taxpayer's trade or business, and should be allowed in full in computing any NOL carryback or carryforward.

The Department is directed to issue the refunds to the Taxpayer for 1991 and 1992. The 1994 final assessment 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 March 31, 1998.

BILL THOMPSON
Chief Administrative Law Judge

BT:ks

cc: Gwen Garner, Esq.
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