

CHARLES L. DENNIS, III
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STATE OF ALABAMA
DEPARTMENT OF REVENUE
ADMINISTRATIVE LAW DIVISION

Taxpayer,

DOCKET NO. INC. 99-422

v.

STATE OF ALABAMA
DEPARTMENT OF REVENUE.

FINAL ORDER

The Revenue Department denied income tax refunds claimed by Charles L. Dennis, III (ATaxpayer@) for 1992, 1993, and 1994. The Taxpayer appealed to the Administrative Law Division pursuant to Code of Ala. 1975, ' 40-2A-7(c)(5)a. A hearing was conducted on August 14, 2000 in Mobile, Alabama. Joe Walvis represented the Taxpayer. Assistant Counsel Duncan Crow represented the Department.

ISSUE

The issue in this case is whether a \$160,000 loss incurred by the Taxpayer in 1995 should be allowed as a net operating loss (ANOL@) carryback to 1992, 1993, and 1994 pursuant to Code of Ala. 1975, ' 40-18-15.2. The carryback can be allowed only if the loss was a Abusiness@loss. See, Code of Ala. 1975, ' 40-18-15.2(5)c.

FACTS

The Taxpayer was unemployed in 1993. He became interested in a new business venture, RUSA Stone Venture, Inc., which was involved in importing granite, marble, and semiprecious stones to the United States from Russia. The stone was to be processed and sold for use in the construction industry.

The Taxpayer invested \$100,000 in the corporation on January 21, 1994. He received a \$100,000 promissory note at zero percent interest from the corporation at that time. The Taxpayer testified that it was the intent of the parties that he would receive stock for his investment, but that because no stock certificates had been prepared, he instead received the promissory note as evidence of his investment.

The Taxpayer invested another \$60,000 in the corporation on April 21, 1994. The Taxpayer received a \$60,000 promissory note at zero percent interest from the corporation at that time.

The Taxpayer also entered into an employment agreement with the corporation on April 21, 1994. The agreement indicated that the Taxpayer would receive a salary of \$75,000 in 1994, and \$100,000 in subsequent years. However, the Taxpayer was to receive a salary only after the capital contributions to the corporation were repaid. The Taxpayer never received any salary from the corporation.

The corporation failed in 1995. Consequently, the Taxpayer lost his investment of \$160,000 in that year. The Taxpayer claimed the loss on his 1995 Alabama return. He also filed amended 1992, 1993, and 1994 returns, and carried the loss back as an NOL to those years.

The Department audited the Taxpayer for 1992 through 1995. The Taxpayer provided the examiner with a copy of the promissory notes and the employment contract discussed above. The examiner allowed the loss in 1995, but treated the loss as a nonbusiness loss, and thus denied the refunds claimed in 1992, 1993, and 1994. The Taxpayer objected.

A Department hearing officer conducted an informal conference on April 17, 1998. The Taxpayer and his representative both attended the conference. The Taxpayer presented the hearing officer with an affidavit from the corporation's president which stated that the Taxpayer had invested the \$160,000 for stock, but that because stock certificates were not available at the time, the Taxpayer was instead issued promissory notes. The affidavit claimed that upon issuance of the stock, Mr. Dennis was to exchange his promissory notes. The affidavit did not mention that stock had been issued. The Taxpayer and his representative also did not inform the hearing officer that stock had been issued.

The hearing officer disallowed the NOL carryback, and consequently denied the refunds, because (1) the \$160,000 investment was not made to save the Taxpayer's job with the corporation, and (2) the loss was not a '1244 stock loss because no stock was ever issued. See, May 13, 1998 letter from Hearing Officer Evelyn Taylor. The Taxpayer appealed.

The parties agreed to meet and attempt to settle the case on March 22, 2000. At that meeting, the Taxpayer's representative for the first time submitted copies of two stock certificates issued by the corporation to the Taxpayer. One certificate is for 1,667 shares, and is dated January 21, 1994. The other is for 1,000 shares, and is dated April 21, 1994. The corporation's president testified at the August 14 hearing that the two stock certificates were issued in late 1994, and backdated to when the Taxpayer invested the money in the corporation. Neither the Taxpayer nor his representative could explain why the Department had not been informed of the existence of the stock certificates before the March 22, 2000 conference.

ANALYSIS

The Department hearing officer succinctly and accurately explained in her May 13, 1998 letter when an investment or advance to a corporation can be treated as a business-related transaction:

A nonbusiness loss is a loss not incurred in a taxpayer's trade or business and is recognized for NOL purposes only up to the amount of nonbusiness income. A taxpayer does not engage in a trade or business when he invests in a corporation, unless the taxpayer is a stockbroker or is otherwise engaged in the business of investing in corporations. An investment or advance to a corporation by a shareholder that is also employed by the corporation may constitute a business transaction, but only if the shareholder/employee's dominant motive is to protect his job with the corporation, not his investment. The stockholder must have a job (a trade or business) to protect before an advance or loan to a corporation can be considered a business transaction. *Trent v. C.I.R.*, 291 F.2d 66, illustrates that investments in a corporation made prior to or concurrent with the investor obtaining a job with the corporation are nonbusiness investments, whereas later advances by the investor/employee for the purpose of saving his existing job may be treated as a business transaction. The taxpayer made loans to the corporation on January 1, 1994 and April 21, 1994; the employment agreement was entered into on April 21, 1994. Since the taxpayer was not an employee of the corporation at the time the loans were made, the loan could not have been made to protect his employment.

See also, *U.S. v. Generes*, 92 S.Ct. 827 (1972); *Brady v. State of Alabama, Inc.* 97-426 (Admin. Law Div. 5/14/98).

Although the Taxpayer did not invest in the corporation for the business-related purpose of saving his job, the loss may still be treated as a business loss for NOL purposes if it involved a § 1244 stock loss.®

Congress enacted 26 U.S.C. § 1244 to encourage investment in small businesses. *Rickey v. C.I.R.*, 502 F.2d 748 (9th Cir. 1974). For federal purposes, § 1244 allows an individual to deduct as an ordinary loss, as opposed to a capital loss, any loss from the

worthlessness of small business stock.⁶ Generally, small business stock is the stock of a corporation that receives less than \$1M in capital contributions. Section 1244(d)(3) also specifies that a loss concerning '1244 stock shall be treated as a business loss for NOL purposes.

Alabama has not adopted '1244 because Alabama does not distinguish between capital losses and ordinary losses. However, Dept. Reg. 810-3-15-.22(1)(b)1.(l) specifies that a business loss for NOL purposes includes a loss on AIRC '1244 stock.⁶ Consequently, if the Taxpayer's loss involved a '1244 stock loss, the NOL carryback to 1992, 1993, and 1994 should be allowed.

The Department hearing officer held that the loss was not a '1244 stock loss because when she made her finding, the Taxpayer had not proved, or even alleged, that stock had been issued. As indicated, however, the Taxpayer's representative later produced two stock certificates at the March 2000 conference. The corporation's president testified that the certificates had been issued in late 1994.

I cannot understand why the Taxpayer and his representative both failed to provide the Department with the stock certificates, or even inform the Department that stock had been issued, until the March 22, 2000 conference. The audit had been ongoing for almost three years at that time. The Taxpayer and his representative both knew as early as May 1998 that the Department refused to treat the loss as a '1244 stock loss because no stock had been issued. They had numerous opportunities before March 2000 to provide the stock certificates, or at least notify the Department that stock had been issued. They failed

to do so. The corporation's president also failed to mention in his affidavit that stock had been issued in 1994. The above facts raise a suspicion that the stock certificates were not issued in 1994, but only later, after the existence of the stock became an issue.

In any case, an objective review of the facts establishes that the Taxpayer's investment of the \$160,000 was in return for an ownership interest in the corporation, and not a loan. If the Taxpayer had intended the money as loans, and not as capital contributions for stock, he certainly would have charged interest on the loans. Because there is evidence that the Taxpayer was issued stock for his contributions to the corporation, the Taxpayer's loss should be treated as a business-related ' 1244 stock loss. The NOL carryback is allowed. The refunds should be issued by the Department.

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

Entered October 26, 2000.