MARK A. & TAMARA BYAL 81 N. TURKEY TROT DADEVILLE, AL 36853-4702,	§	STATE OF ALABAMA ALABAMA TAX TRIBUNAL
	§	DOCKET NO. INC. 15-1280
Taxpayers,	§	
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

FINAL ORDER

The Revenue Department assessed Mark A. and Tamara Byal (together "Taxpayers") for 2012 income tax. The Taxpayers appealed to the Tax Tribunal pursuant to Code of Ala. 1975, §40-2A-7(b)(5)a. A hearing was conducted on June 21, 2016. The Taxpayers and their attorney, David Johnston, attended the hearing. Assistant Counsel Jason Paulk represented the Revenue Department.

The Taxpayers lived in Enterprise, Alabama before and during the year in issue. Mark Byal (individually "Taxpayer") and his adult son, Josh Byal, began discussing in mid-2007 the idea of the Taxpayer loaning Josh money to start a used car wholesale business in Enterprise. Josh had previously bought and sold cars while working at a local automobile dealership.

On January 5, 2008, the Taxpayer and Josh executed a written "Letter of Agreement" whereby the Taxpayer agreed to make draws on his Regions Bank home equity line of credit for the money needed for Josh to start the business. The Agreement also provided that Josh would timely make the loan payments to the Bank; that the Taxpayer would make a return on investment of ten percent of the net profits and have access to the business's financial records; and that the Taxpayer would be allowed to purchase vehicles for his personal use at wholesale cost.

On January 15, 2008, the Taxpayer contracted to loan Jomar Automotive, LLC the funds needed to operate the used car wholesale business previously operated by Josh, individually. Josh owned 100 percent of Jomar Automotive.

On May 7, 2008, Josh Byal and Robert Cox, Jr. formed Unique Automotive, LLC. They each owned 50 percent of the business. Jomar Automotive's motor vehicle inventory was transferred to Unique Automotive, and on May 8, 2008, the Taxpayer and Josh Byal, on behalf of Unique Automotive, executed an agreement whereby Unique agreed to continue paying Regions Bank on the loans previously taken out by the Taxpayer, and also on any loans subsequently taken out by the Taxpayer and used to finance the business. The Taxpayer thereafter continued making draws on his home equity line of credit for use in the business.

Jomar Automotive and Unique Automotive were initially successful. In 2009 or 2010, the business began selling vehicles at retail, and had up to 50 vehicles in inventory that were financed through a floor plan. The Taxpayer checked on the business several times a week, and periodically reviewed its business records to determine if it was profitable. The Taxpayer also borrowed additional money in 2010 and early 2011 secured by land owned by the Taxpayer that he provided to Unique to operate the business.

The business began struggling financially in 2011. The Taxpayer, with advice from his CPA, stopped loaning the business money in mid to late 2011. The business subsequently ceased operating later that year. Josh also stopped making the monthly payments on the loans the Taxpayer had taken out to finance the business.

The Taxpayer and his CPA both testified at the June 21 hearing that neither Josh nor Unique had any assets or net worth after the business closed in 2011. Josh's mother

also gave Josh the money to pay his one-third part of the mortgage on his house. Josh's wife was not gainfully employed, and thus had no income in 2011 and 2012.

Based on the advice of their CPA, the Taxpayers claimed a bad debt deduction of $153,202 on their 2012 Alabama income tax return. The Department audited the return and disallowed the deduction. The Department examiner that audited the Taxpayers testified at the June 21 hearing that she disallowed the deduction because the Taxpayer "did not provide me with enough information that I felt like all measures had been exhausted to collect the debt." (T. 90). She also explained that she was not sure that the loans were arm's-length transactions between the Taxpayer and his son.

Code of Ala. 1975, §40-18-15(a)(5) allows a deduction for nonbusiness bad debts incurred in a transaction entered into for profit in accordance with 26 U.S.C. §165(c)(2). To be deductible, there must be a genuine debt between the debtor and creditor, there must be an enforceable obligation to repay a fixed amount of money, there must be a basis in the bad debt, and the debt must become uncollectible in the year the loss was claimed.

As discussed in *State v. Hann*, Docket Inc. 85-115 (Admin. Law Div. 8/22/1985), the burden is on the taxpayer to prove a valid bad debt deduction.

> In general, the burden of proving a bad debt deduction is on the one claiming it. *Wilson v. U.S.*, 376 F. 2d 280 (1967); *Wortham Machinery Company v. U.S.*, 521 F.2d 160 (10th Cir. 1975). While it has been held that the filing of a legal action for collection of a debt is not absolutely necessary to establish that the debt is worthless, *Barneson v. Smyth*, 85 F.Supp. 657 (1949), as a general rule, the creditor must exhaust every reasonable means of collection before a bad debt deduction is allowed. *Bell v. U.S.*, 120 F.Supp. 931, affirmed 217 F.2d 646 (1954). In any case, and at the very least, in the absence of a suit to collect the amount due, there must be evidence that any action to collect the debt would have been unsuccessful. *Dustin v. C.I.R.*, 467 F.2d 47 (9th Cir. 1972).

Hann at 3.

In this case, there was an arm's-length, genuine debt between the Taxpayer and his son Josh. Josh also had an enforceable contractual obligation to pay, and the Taxpayer had a basis in the debt. The case thus turns on whether the debt became uncollectible in 2012, the year it was claimed. To be deductible, the debt must have been totally worthless in 2012. "To be deductible, nonbusiness bad debts must be totally worthless. You cannot deduct a partially worthless nonbusiness bad debt." IRS Publication 17.

The Taxpayer testified that he knew Josh "was having a really hard time, struggling" financially in 2012. (T. 35). The Taxpayer's CPA also explained that she believed that the debt became worthless in 2012 because Josh had no prospect of gainful employment, and also that he "had no net worth. He had zero net worth." (T. 81.).

The Taxpayer knew in 2012, however, that Josh had started working for a car dealership, Sam Boswell Motors, in Enterprise in 2012. But although the Taxpayer knew that his son was gainfully employed in 2012, he never inquired as to his son's income in that year. When told at the June 21 hearing that Josh had reported income of $78,307 on his 2012 Alabama return, the Taxpayer testified that he was surprised. (T. 43.).

A taxpayer can be allowed a bad debt deduction if the taxpayer can show that he took all reasonable steps to collect the debt, and that any additional collection attempts would have been unsuccessful. IRS Publication 17. The Taxpayer failed to do so in this case.

After reporting almost $80,000 in income on his 2012 Alabama return, Josh reported adjusted gross income of $95,045, $102,725, and $105,812 on his 2013, 2014, and 2015 Alabama returns, respectively. The Taxpayer's CPA testified that if she had known in 2012 how much Josh would make in the future, she "would have known eventually he could

have paid it. . . ." (T. 83). I agree that in determining if a debt is uncollectible, only the facts known at the time should be considered. But while the Taxpayer's CPA may not have known that Josh was employed in 2012, when the Taxpayers filed their 2012 return in 2013, the Taxpayer was aware that Josh had worked at Sam Boswell Ford in 2012. He thus could have discovered the amount of Josh's 2012 income, either by asking Josh or through garnishment or other legal proceedings. He thus could have reasonably discovered that his son earned almost $80,000 in 2012. If he had done so, he could have thereafter attempted to collect at least a portion of the amount due in 2013 and subsequent years. And with the knowledge that Josh had earned considerable income in 2012, the Taxpayer also could have reasonably expected for him to earn at least as much or more money in subsequent years from which the debt could be repaid.

In summary, when the Taxpayers claimed the bad debt on their 2012 return filed in 2013, at least the Taxpayer knew that his son had worked in 2012, and thus could have reasonable inquired as to his 2012 income. If he had done so, he would have discovered that Josh had sufficient income to pay off at least some of the debt in issue. That is, he would have learned that the debt had not become totally worthless in 2012, and that there was some reasonable chance that at least some if not all of the debt could be eventually collected.

I do not fault the Taxpayers' CPA for advising the Taxpayers to claim the bad debt deduction on their 2012 return because there is no indication she knew that Josh was gainfully employed and may have had substantial income in 2012. The Taxpayer knew, however, and was thus required to investigate if Josh's 2012 income (and future income from the dealership) was a reasonable avenue for collection of the debt. He failed to do

so, and thus failed to "exhaust every reasonable means of collection," as required for a bad debt deduction to be allowed. *Bell v. U.S.*, supra.

The Department's disallowance of the Taxpayers' 2012 bad debt deduction was proper. The final assessment in issue is affirmed. Judgment is entered against the Taxpayers for $2,441.16. Additional interest is also due from the date the final assessment was entered, August 11, 2015.

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

Entered August 8, 2016.

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BILL THOMPSON
Chief Tax Tribunal Judge

bt:dr
cc: Jason C. Paulk, Esq.
G. David Johnston, Esq.