

RICHARD M. POWELL
c/o Powell & Company, PA
3905 Shannon Lane
Birmingham, AL 35213,

Taxpayer,

v.

STATE OF ALABAMA
DEPARTMENT OF REVENUE.

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STATE OF ALABAMA
DEPARTMENT OF REVENUE
ADMINISTRATIVE LAW DIVISION

DOCKET NO. INC. 03-1160

FINAL ORDER

The Revenue Department denied a refund of 2001 income tax requested by Richard M. Powell ("Taxpayer"). 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 April 15, 2004. The Taxpayer attended the hearing. Assistant Counsel Mark Griffin represented the Department.

The Taxpayer has been a practicing CPA since 1968. However, he has worked only part-time as an accountant in the last few years. The Taxpayer testified at the April 15 hearing that he spent most of his time actively buying and selling stocks in 2001 and 2002.

The Taxpayer reported and paid tax on income of \$269,425 from his stock trading activities in 2001. He reported a loss of \$256,346 from his 2002 stock transactions. He subsequently filed an amended 2001 Alabama return on which he carried the 2002 stock loss back to 2001 and claimed a refund. The Department disallowed the NOL carryback because it determined that the Taxpayer was not in the trade or business of buying and selling stocks. The Department's position is based on Code of Ala. 1975, §40-18-15.2(5)c., which provides in substance that nonbusiness losses can be allowed for NOL purposes only to offset nonbusiness income.

The Taxpayer argues that he should be allowed to carryback the stock loss because he was in the trade or business of trading stocks in 2002. He also claims in the alternative that disallowing nonbusiness losses when computing an NOL is improper. The Taxpayer explained his alternative position in an April 14, 2004 letter, as follows:

Through 12/31/84, the Alabama personal net operating loss (NOL) was any minus or negative taxable income after subtracting exemptions. Starting in 1985 the Alabama NOL was the excess of business deductions over business income reduced by the excess of nonbusiness income over nonbusiness deductions. All capital gains and deductible capital losses were classified as business for Alabama purposes. These changes were intended to adopt the federal rules with respect to NOL's except that Alabama had an unlimited deduction for business and investment capital losses whereas the Federal rules limited capital loss deductions to \$3,000 per year with a 50,000 per year, per person exception for losses under Federal Code Section 1244. The new rule under 810-3-15-.27 filed on 02/01/01 improperly limits Alabama business capital losses to those allowed by Code Sec 1244 even though 1244 is not in the Alabama Statute. All capital losses are deductible on Alabama individual tax returns and therefore should not be limited by a Federal Statute which conflicts with Alabama law. To hold otherwise would be grossly unfair because business capital losses in excess of current year's taxable income would be lost forever and capital gains in an ensuing year would be fully taxable. Alabama corporations have adopted the Federal rules with respect to capital losses starting around 2001. Under these new rules, capital losses can not be deducted against other income but they can be carried forward to reduce ensuing capital gains. Even individuals, under Federal rules can carryforward unused capital losses for the rest of their life for utilization against ensuing capital gains. In summary, a regulation can not arbitrarily apply a federal Statute (code Sec. 1244) which conflicts with an Alabama Statute (the unlimited deduction of business capital losses) to reduce a net operating loss deduction.

The issue of whether an individual that traded stocks was engaged in a regular trade or business was addressed in *Shunnarah v. State of Alabama, Inc.* 96-467 (Admin. Law Div. 2/3/98), as follows:

A loss can be used in computing an NOL only if it was incurred in a trade or business. See, Code of Ala. 1975, §40-18-15(16)f.3. (now, §40-18-15.2(5)c.) (Non-business deductions allowed for NOL purposes only to offset non-business income). Consequently, the stock losses incurred in 1990 and

1991 can be carried forward as an NOL to 1993 only if the Taxpayer was in the business of trading stocks, and not merely an investor.

"Whether a taxpayer's trading activities rise to a level which constitutes a trade or business is a question of fact and circumstances." Estate of Yeager v. Commissioner, T.C. Memo 1988-264, affirmed, 889 F.2d 29 (2nd Cir. 1989).

In Yeager, the Tax Court distinguished between (1) a dealer, who actively buys and sells stocks for customers and provides services to the customers, (2) a trader, who operates like a dealer, except only for himself, and (3) a passive investor, who owns stock primarily for dividend income and long-term gain. Dealers and traders are engaged in a trade or business. A passive investor is not.

Various facts must be considered in distinguishing a trader from an investor, including the regularity and continuity of the activity, and the individual's knowledge of and time spent studying stocks, among others. The deciding factor, however, is whether the individual bought and sold stock to take advantage of short-term swings (trader), or for dividend income and long-term appreciation (investor). Purvis v. CIR, 530 F.2d 1332 (1976); Chiang Hsiao Liang, 23 T.C. 1040, 1043. That question is determined in large part by the holding period of the stocks.

"His activity with respect to the management of his holdings was continuous, regular, and conducted for profit. Despite the impressive nature and extent of Yeager's stock market trading activities, however, this is not the sole determination of the issues. The pivotal issue is whether Yeager was interested in deriving income from capital appreciation or from short-term trading. In resolving this issue we cannot summarily dismiss those cases which indicate that the length of the holding period is a crucial factor in determining whether a taxpayer's trading activities rise to the level of a trade or business. (cites omitted) As we recently noted in King v. Commissioner, supra at 461, '[T]he primary characteristic which differentiates the activities of a trader from those of an investor is that a trader seeks short-swing gains while an investor seeks long-term appreciation.'"

Yeager, at page 1106.

In this case, the Taxpayer bought or sold stock 56 times in 1990 and 122 times in 1991, again assuming that he made the same number of purchases as sales in each year. The average holding period for an

individual stock was approximately 2 years. The above facts indicate that the Taxpayer was an investor during the subject years, not a trader.

Shunnarah at 2 – 4.

The Department determined that the Taxpayer in this case was not in the trade or business of trading stocks because he reported only 32 stock trades on his 2001 Schedule D and only 31 trades on his 2002 Schedule D.

However, the Taxpayer presented evidence at the April 15 hearing that he sold stocks well over 100 times in 2002 alone. He also had almost 50 open or closed call transactions in 2002 that resulted in over \$200,000 in net income. And unlike the taxpayer in *Shunnarah*, the Taxpayer generally held his stocks for short periods, which indicates that he was buying and selling to take advantage of short-term swings. “The deciding factor, however, is whether the individual bought and sold stock to take advantage of short-term swings (trades), or for dividend income and long-term appreciation (investor).” *Shunnarah*, *supra* at 2, citing *Purvis v. CIR*, 530 F.2d 1332 (1976); *Chiang Hsiao Liang*, 23 T.C. 1040, 1043. The evidence thus supports a finding that the Taxpayer was in the business of trading stocks in 2002, and thus was entitled to carry his 2002 business-related stock loss back to 2001. The 2001 refund claimed on the Taxpayer’s amended 2001 return should be granted.

An in-depth discussion of the Taxpayer’s alternative argument is pretermitted by the above holding. I will add, however, that I disagree with the argument. The fact that Reg. 810-3-15-.27 recognizes a loss on §1244 stock as a business loss does not mean that all nonbusiness losses should be allowed in computing an NOL. To the contrary, §40-18-15.2(5)c. clearly allows nonbusiness losses for NOL purposes only to offset nonbusiness

income.

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

Entered August 10, 2004.

BILL THOMPSON
Chief Administrative Law Judge