

DONALD K. STRONG
25 Hickorywood Lane
Springville, AL 35146,
DIVISION

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§

STATE OF ALABAMA
DEPARTMENT OF REVENUE
ADMINISTRATIVE LAW

Taxpayer,

§

DOCKET NO. INC. 00-312

v.

§

STATE OF ALABAMA
DEPARTMENT OF REVENUE.

§

FINAL ORDER

The Revenue Department assessed 1999 income tax against Donald K. Strong (“Taxpayer”). 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 August 29, 2000 in Birmingham, Alabama. The Taxpayer represented himself. Assistant Counsel LaRonica Lightfoot represented the Department.

The Taxpayer suffered losses on the sale of stocks in 1997 and 1998. The issue in this case is whether those stock losses can be allowed in computing a net operating loss (“NOL”) pursuant to Code of Ala. 1975, §40-15-15.2. That issue turns on whether the losses were “non-business.” If so, the losses can only be applied to offset “non-business” income. Section 40-18-15.2(5)c.

The Taxpayer is a CPA. He was employed in Mississippi until mid-1996, at which time he moved to Alabama. He filed a 1996 Alabama return on which he claimed a Schedule C loss of \$18,620 relating to a consulting business (Medtech Systems) he started in that year.

The Taxpayer filed a 1997 Alabama return on which he again claimed a Schedule C loss from Medtech Systems. He also claimed a loss of \$36,434 from the sale of stock.

The Taxpayer filed a 1998 Alabama return on which he reported a Schedule C loss of \$8,660 concerning another consulting business, Computax Accounting Services. He also claimed a \$40,799 stock loss.

The Taxpayer filed a 1999 Alabama return on which he reported a stock gain of \$161,345, a taxable IRA distribution of \$64,329, and interest and dividend income of \$1,379. The Taxpayer also claimed an NOL carryover from 1996 of \$13,692; 1997 of \$40,193; and 1998 of \$48,894.

The Department allowed the NOL carryover relating to the Taxpayer's Schedule C business-related losses in 1996, 1997, and 1998. The Department disallowed, however, that part of the NOL relating to the stock losses. The Department claims the stock losses were not incurred in the Taxpayer's trade or business, and thus could not be considered in computing an NOL pursuant to the modification at §40-18-15.2(5)c. The Department adjusted the Taxpayer's liability, and assessed the Taxpayer accordingly. The Taxpayer appealed.

Alabama law allows an individual to carry an NOL back 2 years and forward 15 years. Section 40-18-15.2(2). However, as stated, losses not attributable to a taxpayer's trade or business, i.e., "non-business" losses, are allowed only to offset "non-business" income. Section 40-18-15.2(5)c. The issue in this case thus is whether the Taxpayer's 1997 and 1998 stock losses were attributable to a trade or business.

The Taxpayer began investing in the stock market in late 1996. He incurred losses of \$36,434 and \$40,799 in 1997 and 1998, respectively. He realized a stock gain of \$161,345 in 1999. At issue is whether he can offset the 1999 gain with the 1997 and 1998 losses.

The criteria for determining if an individual's stock losses were incurred in a trade or business was set out in *Mousa M. & Naimeh Shunnarah v. State of Alabama*, Docket 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. (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 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.

The above is supported by the holding in Yeager, in which the Court found that the taxpayer was an investor, not a trader, even though he studied stocks full time and made over 1200 and 1100 stock transactions during the two years in issue. In Muller v. U.S., 721 F.2d 810 (1984), the Court determined that 124 and 106 trades during the two years in issue were not sufficient to make the taxpayer a trader. In Cosby v. Ala., Dept. of Rev., Docket Inc. 92-180 (Admin. Law Div. 12/15/92), the Administrative Law Division determined that 50 trades in a year did not raise the taxpayer to the level of a trader.

Shunnarah, at 2-4.

The Taxpayer in this case claims he actively bought and sold stocks. However, he failed to present any evidence establishing the frequency of his stock sales. The burden was on the Taxpayer to prove that he is entitled to the claimed deduction. U.S. v. Wodtke, 627 F.Supp. 1034 (1985). Consequently, because the Taxpayer failed to prove he was a stock trader, and thus engaged in a trade or business, the Department correctly disallowed the stock losses in computing the NOL.

The *prima facie* correct final assessment is affirmed. Judgment is entered against the Taxpayer for \$3,038.83, plus applicable interest.

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

Entered September 27, 2000.