

BOBBY H. & NANCY J. HARVEY  
6000 HIGHWAY 114  
ALICEVILLE, AL 35442,

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STATE OF ALABAMA  
DEPARTMENT OF REVENUE  
ADMINISTRATIVE LAW DIVISION

Taxpayers,

§

DOCKET NO. INC. 06-135

v.

§

STATE OF ALABAMA  
DEPARTMENT OF REVENUE.

§

### FINAL ORDER

The Revenue Department assessed Bobby H. and Nancy J. Harvey (jointly “Taxpayers”) for 1997, 1998, 1999, 2000, 2001, and 2002 income tax. The Taxpayers appealed to the Administrative Law Division pursuant to Code of Ala. 1975, §40-2A-7(b)(5)a. A hearing was conducted on August 9, 2006. Richard Pyper represented the Taxpayers. Assistant Counsel J.R. Gaines represented the Department.

Bobby Harvey (individually “Taxpayer”) was the primary shareholder in Elmore Sand and Gravel, Inc. (“Elmore Sand”) before 1997. Elmore Sand had elected S corporation status with the IRS in August 1992. The Taxpayer sold his shares in Elmore Sand to Southern Ventures, Inc. in October 1997. The sale constituted a tax-free transaction pursuant to 26 U.S.C. §368(a)(1)(b). Elmore Sand subsequently filed short-year 1997 federal and Alabama S corporation returns for January 1, 1997 through October 30, 1997. The federal return included a note stating that it was the final S corporation return because the corporation “agreed to participate in IRS Section Code 368(a)(1)(B).”

The Taxpayer reacquired his stock in Elmore Sand in 1999. He again sold his interest in the corporation in 2004. The new owners subsequently filed State and federal C corporation returns for Elmore Sand in 2004 and paid the tax due.

The IRS and the Department rejected the C corporation returns and returned the money submitted with the returns because its records did not show that Elmore Sand had terminated its S corporation status. The IRS also instructed Elmore Sand to file S corporation returns. The new owners complied by filing S corporation returns for the subject years with the Department and the IRS in February 2005.

The Department assessed the Taxpayer, individually, as a shareholder in Elmore Sand, based on the income reported by Elmore Sand on its 1997 through 2002 S corporation returns. The IRS has, to date, not contacted the Taxpayers concerning the S corporation income.

This case turns on whether Elmore Sand qualified as an Alabama S corporation during the years in issue. If so, the S corporation's income passed through to the Taxpayer, and the Taxpayer would thus be liable for the tax in issue. See generally, Code of Ala. 1975, §40-18-160 et seq.

An Alabama S corporation is a corporation that has elected S corporation status for federal purposes pursuant to 26 U.S.C. §1362. See, Code of Ala. 1975, §40-18-160(b). Section 40-18-160(b) further provides – “No corporation shall be an Alabama S corporation for any portion of a taxable year of the corporation during which an election under 26 U.S.C. §1362 or §1361(b)(3), whichever is applicable, is not in effect for federal income tax purposes.”

26 U.S.C. §1361(a)(1) defines “S corporation” as a “small business corporation for which an election under Section 1362(a) is in effect for such year.” A “small business corporation” is defined as a domestic corporation which does not have more than 75 shareholders and does not have a shareholder that is not an individual. 26 U.S.C.

§1361(b)(1). A corporation's election to be a small business corporation pursuant to 26 U.S.C. §1362 terminates "whenever . . . such corporation ceases to be a small business corporation." 26 U.S.C. §1362(d)(2)(A). The termination is effective "on or after the date of cessation." 26 U.S.C. §1362(d)(2)(B).

The Taxpayer sold his shares in Elmore Sand to Southern Ventures, Inc. in October 1997. Southern Ventures, Inc. became the primary shareholder of Elmore Sand at that time. Because Southern Ventures, Inc. is not an individual, Elmore Sand's prior election as a federal S corporation was terminated effective that date. See, Treas. Reg. 1.1361-1(f) (" . . . a corporation in which any shareholder is a corporation, partnership, or trust does not qualify as a small business corporation"). Because Elmore Sand's federal election to be an S corporation terminated in October 1997, the corporation also ceased being an Alabama S corporation at that time pursuant to §40-18-160(b).

The Department argues that the Taxpayer "failed to clearly establish that (Elmore Sand's) S corporation status had been terminated on the federal level." Department's Post-Hearing Brief at 4. I disagree. The Taxpayer presented evidence at the August 9 hearing establishing that Southern Ventures, Inc. became a shareholder of Elmore Sand in October 1997. There is thus evidence that Elmore Sand's status as an S corporation ended by operation of law at that time.

The Department contends that the IRS has never acknowledged that Elmore Sand's S corporation status was terminated. However, Elmore Sand in substance notified the IRS with its "final" part-year 1997 S corporation return that it would no longer be an S corporation because of the §368 transaction.

In any case, the fact that the IRS has never formally acknowledged that Elmore Sand ceased being an S corporation does not require Alabama to continue treating the entity as an S corporation. A corporation qualifies as an Alabama S corporation under Alabama law only as long as the corporation's federal S corporation status is in effect. As discussed, Elmore Sand's federal status as an S corporation terminated by operation of law when Southern Ventures, Inc. became a shareholder in Elmore Sand in October 1997. It is irrelevant that the IRS has failed to acknowledge the termination.

The Department also contends that the Taxpayer personally benefited when the Department refunded the taxes paid by Elmore Sand with its C corporation returns because the Taxpayer partly owned Southern Ventures, Inc. and served for a time as that corporation's chief operating officer. The Taxpayer disputes that claim. He argues that he was no longer involved when the Department returned the taxes paid with the C corporation returns, and that only the unrelated new owners benefited. But whether the Taxpayer benefited from the returned money is irrelevant to the issue of whether the Taxpayer is liable for the tax in issue, i.e., whether Elmore Sand was an S corporation during the subject years.

The final assessments in issue are voided.<sup>1</sup>

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

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<sup>1</sup> The Department may still assess Elmore Sand as a C corporation for the tax due in the subject years. Elmore Sand filed the C corporation returns in 2004. The Department has three years from when the returns were filed, or until sometime in 2007, to assess the C corporation for the tax due. See, Code of Ala. 1975, §40-2A-7(b)(2).

Entered December 13, 2006.

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BILL THOMPSON  
Chief Administrative Law Judge

bt:dr

cc: Cleophus Gaines, Jr., Esq.  
Richard L. Pyper, Esq.  
Kim Peterson