JERRY W. & NANCY MILNER 187 MULLIS CREEK PIKE ROAD, AL 36064-2351,	§ §	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayers,	§	DOCKET NO. INC. 09-472
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

FINAL ORDER

The Revenue Department partially denied a refund of 2007 income tax requested by Jerry W. and Nancy Milner (together "Taxpayers"). The Taxpayers appealed to the Administrative Law Division pursuant to Code of Ala. 1975, §40-2A-7(c)(5)a. A hearing was conducted on January 12, 2010. Jerry Milner (individually "Taxpayer") and the Taxpayers' representatives, Will Sellers and CPA Janet Johnson, attended the hearing. Assistant Counsel Mark Griffin represented the Department.

The Taxpayer established a financing business in Alabama in 2004. He entered into a factoring agreement with his brother, Richard Milner, and his brother's business, JRT Inc., d/b/a American Door and Molding, in 2004. American Door sold doors and other building materials to construction companies and others at retail.

The factoring agreement required that when American Door made a sale to a customer, the Taxpayer would pay the business the sales price, less an agreed upon fee. When the customer paid American Door, the business was required to deposit the proceeds into the Taxpayer's factoring account. The parties renewed the factoring agreement annually, with the last agreement executed in July 2007.

The Taxpayer profited from his factoring business in 2004, 2005, and 2006. He reported and paid State and federal income tax on the income derived from the business in

those years.

Richard Milner's wife helped him operate American Door. She became seriously ill in late 2006, and spent several weeks in the intensive care unit at a local hospital. Richard Milner had an emergency appendectomy in early 2007, and fought complications from the surgery over the next few months. The illnesses adversely affected the couple's ability to operate American Door, which resulted in a decline in the business's sales. The construction industry also correspondingly suffered a serious decline in 2007. As a consequence, American Door closed its doors and went out of business in August 2007.

Before American Door closed, the company also used the receipts from the factored sales to pay its operating expenses instead of depositing them into the Taxpayer's factoring account. Various of the business's other creditors also sued and obtained judgments against the business and Richard Milner, individually. The Taxpayer was aware of those liens, and also knew that his brother was financially destitute and could not pay his secured judgment creditors, much less the $180,000 plus that his brother owed under the factoring agreement. The Taxpayer consequently decided not to sue his brother, thus avoiding the costs he would have incurred in doing so.

The Taxpayers filed a 2007 Alabama return on which they reported a small amount of income received pursuant to the factoring agreement in early 2007. They also deducted the $183,000 plus that Richard Milner owed under the factoring agreement as a business bad debt on the return.

The Department reviewed the return and questioned the timing of the bad debt deduction. That is, it disputed that the debt had become worthless in 2007. It consequently disallowed the bad debt deduction, which reduced the refund claimed on the

return.[1]

The Administrative Law Division previously addressed the business bad debt deduction in *State v. Hann*, Inc. 85-115 (Admin. Law Div. 8/22/1985), as follows:

> Code of Alabama 1975, §40-18-15, provides for a bad debt deduction as follows:
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> > (a) In computing net income, there shall be allowed as deductions:
> >
> > (7) Losses from debts ascertained to be worthless and charged off during the taxable year of such ascertainment, if sustained in the conduct of the regular trade or business of the taxpayer during the period covered by an Alabama income tax law;
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> That section is in substance identical to the federal deduction for bad debts found at 26 U.S.C.A. , §166. Where a state statute is identical in content to a federal statute, interpretations and decisions relevant to the federal law should be followed in cases pertaining to the similar state statute. *State v. Gulf Oil Corporation*, 256 So.2d 172 (Ala. Civ. App. 1971).
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> 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).
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> As to the timing of a bad debt deduction, the burden is on the taxpayer to establish that the debt became worthless during the tax year. *Wilson v. U.S.*,

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[1] The Department argued in its Answer that the bad debt could not be deducted because it was personal in nature. As indicated, however, the Department initially never questioned whether the loss was business-related, and instead disallowed the bad debt only because it determined that the debt did not become worthless in 2007. The Department now apparently concedes, correctly, that the debt was business-related because its brief only addresses the timing issue.

> supra. There must be some event in the tax year, such as a suit to collect the debt or a change in the debtor's financial position, to allow the write-off in that year, *Herskovits v. C.I.R.*, 110 F.2d 272 (2nd Cir. 1940), and if the debtor is insolvent at the beginning of the tax period, the debt cannot become worthless during the year. *W. F. Young, Inc. v. C.I.R.*, 120 F.2d 159 (1st Cir. 1941).

Hann at 2 – 3.

The Taxpayer in this case did not sue his brother or take any other affirmative action to collect the amount owed because he knew that his brother could not pay. As indicated, however, even if collection is not attempted, a bad debt deduction can still be claimed if there is evidence that any attempted collection action would have been unsuccessful. And a substantial negative change in the debtor's financial condition in a year may be sufficient to allow a bad debt write-off in that year.

The Taxpayer is a successful businessman who knew from the facts and circumstances surrounding his brother's financial status in 2007 that his brother would not be able to pay the amount he owed under their factoring agreement. The fact that American Door had previously used all account receivable payments to continue operating (in lieu of depositing them in the Taxpayer's factoring account) also supports the Taxpayers' claim that the debt was uncollectible in 2007. The brother's financial status also took a severe turn for the worse in 2007.

For a creditor to be allowed to deduct a bad debt in a given year, "[h]e must show that there was no hope of recovering anything from the debtor." *Bell v. United States*, 120 F.Supp 931 (1959). The evidence shows that the Taxpayer had no chance of recovering or being paid the debt in issue. The Taxpayers thus should be allowed to deduct the business bad debt on their joint 2007 return. The refund claimed on that return should be allowed in

full. Judgment is entered accordingly.

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

Entered February 25, 2010.

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BILL THOMPSON
Chief Administrative Law Judge

bt:dr
cc: Mark Griffin, Esq.
William B. Sellers, Esq.
Kim Peterson