

STEVEN J. SHELTON AND
LORI S. MILLWOOD
1354 NEWPORT PLACE
GREENVILLE, MS 38701-8320,

Taxpayers,

v.

STATE OF ALABAMA
DEPARTMENT OF REVENUE.

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STATE OF ALABAMA
DEPARTMENT OF REVENUE
ADMINISTRATIVE LAW DIVISION

DOCKET NO. INC. 09-605

FINAL ORDER

The Revenue Department assessed Steven J. Shelton and Lori S. Millwood (together "Taxpayers") for 2005 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 November 17, 2009. CPA Harvey Cutter represented the Taxpayers. Assistant Counsel Mark Griffin represented the Department.

Department examiners in Huntsville, Alabama audited the Taxpayers' 2004 and 2005 Alabama income tax returns and determined that (1) the 2004 return was substantially correct and that the Taxpayers were due a refund of approximately \$19,000 for that year, and (2) the Taxpayers owed additional 2005 tax of over \$198,000.

The examiners forwarded the audit report to the Department's audit verification unit in Montgomery. That unit adjusted the audit to show that the Taxpayers owed \$2,969 for 2004 and \$34,707 for 2005. It subsequently entered final assessments against the Taxpayers for both years. The Taxpayers appealed the 2004 final assessment to the Administrative Law Division.¹

¹ The Taxpayers were involved in divorce proceedings when the final assessments were entered. Consequently, they both separately appealed to the Administrative Law Division.

A hearing was conducted in November 2008. After the hearing, the Department was directed to explain why the audit verification unit had adjusted the examiners' audit report. The Department subsequently notified the Administrative Law Division that the examiners' audit report was correct, and consequently, that the final assessments in issue were incorrect. The Administrative Law Division thereafter issued a Final Order voiding the 2004 final assessment and directing the Department to issue the Taxpayers a refund for that year, as indicated in the examiners' audit report. The Final Order also indicated that the Department was voiding the 2005 final assessment, and that the Department would reassess the Taxpayers for the 2005 tax due as shown in the examiners' audit report.

The Department entered another 2005 final assessment against the Taxpayers on May 18, 2009 for \$188,053.02. That final assessment is the subject of this appeal. A hearing was conducted on November 17, 2009. CPA Harvey Cutter again represented Steven Shelton (individually "Taxpayer"). Assistant Counsel Mark Griffin represented the Department.

The relevant facts and the Department's position are stated in its Answer, as follows:

The State of Alabama Department of Revenue ("ADOR"), in response to the Taxpayers', Steven Shelton and Lori Millwood, appeal of a 2005 Alabama income tax assessment in the amount of \$188,053.02, states:

I. Facts:

In 1999, the Taxpayer, Steven Shelton (hereinafter "Shelton") became a minority member (less than 15% shareholder) of a limited liability corporation ("LLC"), STG Media, LLC. The LLC owned several radio stations in Alabama. Shelton was employed by at least one of the radio stations. Black Crow Broadcasting/Media, LLC ("Black Crow") was the majority member (85% shareholder) of STG Media, LLC.

There is no documentation to show that Shelton contributed any money or assets to STG Media, LLC. Accordingly, Shelton's original basis in the LLC

was zero.

In 2001, STG Media, LLC merged with another LLC, also named STG Media, LLC, but with a different federal identification number. STG Media, LLC filed a 2001 federal partnership return with the Internal Revenue Service. Attached to that return was Form 8594 - 'Asset Acquisition Statement.' The statement refers to a merger of the two LLCs and notes that the second LLC is a continuation of the original. Further, the form states that "[t]he member's distributive shares of income, gains, losses, deductions, credit (and each item thereof) are identical before and after the merger...". In 2005, STG Media, LLC, changed its name to Rocket City Broadcasting, LLC, but the LLC retained its federal identification number.

On his 1999 through 2005 Alabama income tax returns, Shelton claimed losses totaling \$3,053,699.00, including a \$205,399.00 loss on his 2005 return. The reported losses flowed through to Shelton from the referenced LLCs. The 1999 through 2004 losses in the total amount of \$2,848,300.00 were allowed.

Shelton never reported any income from the LLCs on his returns. However, Shelton received a "final" K-1 from Rocket City Broadcasting, LLC. The K-1, dated December 31, 2005, reports a \$500,000.00 distribution to Shelton. This distribution was made in exchange for Shelton's sale or exchange of his approximate 15% interest in the LLC to Black Crow.

In computing Shelton's 2005 Alabama income tax, ADOR recaptured as a gain on the exchange of Shelton's interest in the LLCs, the flow-through losses of the LLC taken on Shelton's 1999 through 2005 Alabama income tax returns. In addition, ADOR added the \$500,000.00 K-1 distribution to Shelton's 2005 taxable income for a total 2005 gain of \$3,553,699.00. These adjustments result in the subject assessment of \$188,053.02.

II. Issue:

The issue of this appeal is the correct computation of Shelton's 2005 Alabama income tax.

III. Department's Position:

In his appeal notice, Shelton asserts that his 2005 "[g]ain to be recognized" is \$761,187.00 (Appeal Notice, p. 2), rather than \$3,553,699.00. Shelton's calculation of the gain uses a "12/31/2004 basis" in the LLC in the amount of \$3,407,352.00 (Appeal Notice, p. 2) and a "[d]ecrease in [d]ebt" of \$3,626,951.00. (Appeal Notice, p. 2). Presumably, Shelton's "decrease in debt" figure is the equivalent of the recapture of claimed LLC losses.

ADOR previously conducted a cursory review of Shelton's 2004 Alabama income tax return pursuant to a prior audit. ADOR reviewed Shelton's 2004 return and made no adjustment to the reported LLC basis. There is no evidence, however, to indicate that ADOR requested a substantiation of the 2004 LLC basis from Shelton. Nonetheless, Shelton now asserts that ADOR must accept his calculation of the basis, because of the prior review of the 2004 return.

Shelton's assertion is apparently based on the doctrine of estoppel. Shelton claims that ADOR should be estopped from denying the 2004 LLC basis previously reviewed and accepted by ADOR on the 2004 return. ADOR, however, can not be estopped from assessing and collecting a tax that is legally due. Ex parte Four Seasons, 450 So. 2d 110, 112 (Ala. 1984). See also Ala. International Dragway, Inc. v. ADOR, ALD Docket No. S. 00-331, "Opinion and Preliminary Order," p. 4 & 5 and Altheria Jones - Miles v. ADOR, ALD Docket No. INC. 05-627, "Preliminary Order Denying Motion to Dismiss," p. 3. Accordingly, ADOR is not bound by Shelton's basis calculation.

ADOR has determined that Shelton had no basis in the LLC. Further, Shelton has not presented evidence to document a basis. The admitted "decrease in debt" of \$3,626,951.00 (characterized by ADOR as recapture of LLC losses) results in a taxable gain of approximately \$3.5 million and the correct assessment of \$188,053.02.

The Taxpayers' position is stated in their representative's appeal letter, as follows:

We disagree that the Alabama Department of Revenue has the right to change the audit, final assessment, and tax lien without starting the audit process over. The Department had reviewed the audit and determined that \$34,082.96 was due. The department issued a final assessment on June 17, 2008 and a tax lien on August 19, 2008. The State of Alabama regulations state "No taxpayer shall be subjected to unnecessary examination or investigation, and only one inspection of a taxpayer's book or accounts shall be made for a taxable year unless the taxpayer requests otherwise or unless the Department of Revenue, after investigation, notifies the taxpayer in writing that an additional inspection is necessary, together with the reasons for such additional inspection." The Alabama Department of Revenue did not notify the taxpayer in writing that an additional inspection was necessary or the reasons for the inspection.

We disagree with the third audit report attached to the preliminary assessment. The auditor disallowed the taxpayer's basis in the LLC without reviewing the basis worksheets. The auditor states in the report that the taxpayer's basis was reduced to zero in 2005. The auditor then states that the taxpayer had no basis in the LLC. The auditor cannot have it both ways

either that taxpayer had or did not have basis. The loss claimed in prior years is included in the basis calculations therefore the recapture of the losses claimed in prior years is not valid. The Department has repeatedly audited the taxpayer and repeatedly found that the taxpayer had basis in the LLC. The department found that the taxpayer had basis of \$3,407,352 on 12/31/2004. The auditor states that the taxpayer's basis was reduced to zero but not how the basis was reduced. The previous losses are calculated as part of the basis that was in the basis at the beginning of the year. Recapture of the previous losses is not allowed because the previous losses are included in the basis calculation that was audited and accepted as of 12/31/2004 by the auditor. The auditor cannot explain what happened to this starting basis. The regulations state that the taxpayer's basis is increased by the amount of recourse debt, and any income or contributions. The basis is reduced by any losses, or distributions. The auditor found basis as of 12/31/2004, this is the opening balance for basis calculations for 2005. \$3,407,352 in basis did not just disappear because the taxpayer sold the LLC to the other members in the LLC, or that the taxpayer had claimed losses on his prior tax returns. There is no provision for recapture of previous deducted losses in the regulations.

The basis worksheet shows the following:

	Basis
12/31/2004 Basis	3,407,352
Current year loss	- 205,399
Current year loss	4
Current year loss	66
Disallowed NOL	163,881
Decrease in Debt	-3,626,951
Distribution	- 500,000
Basis 12/31/2005	<u>- 761,187</u>
Gain to be recognized	761,187

The Taxpayers first argue that the Department violated the Uniform Revenue Procedures Act, Code of Ala. 1975, §40-2A-7 et seq., when it entered the second 2005 final assessment; and specifically, Code of Ala. 1975, §40-2A-7(b)(2)j., which provides that no taxpayer shall be subject to unnecessary examination, and that the Department may reinspect a taxpayer's records only after notifying the taxpayer in writing that a reinspection

is necessary.

The Department did not violate §40-2A-7(b)(2)j. because a second inspection or audit of the Taxpayers' records was not required or necessary. The Department simply entered the second 2005 final assessment against the Taxpayers based on its prior audit of the Taxpayers. That is clearly authorized by §40-2A-7(b)(2)j., which provides that "[a]dditional tax may be assessed by the department within any applicable period allowed above, even though a preliminary or final assessment has been previously entered by the department against the same taxpayer for the same or a portion of the same tax period."

The Taxpayers also argue that the Department had accepted the Taxpayers' claimed basis in the LLC because it had previously audited the Taxpayers and allowed the claimed LLC losses in prior years. But the Department allowed the prior years losses based on the presumption that the Taxpayer had a basis in the LLC equal to or greater than the losses claimed. That is, it never requested records in the prior audits establishing the Taxpayer's basis in the LLC, i.e., his contributions to the LLC or the amount of LLC debt that the Taxpayer had assumed. The fact that the Department never required the Taxpayer to prove his basis in the LLC in prior audits does not bar the Department from requesting such proof in a subsequent audit.

The Department examiners requested records concerning the Taxpayer's basis in the LLC when they audited the Taxpayers' 2004 and 2005 returns. The Taxpayers failed to provide the examiners with any records showing a basis in the LLC. The examiners thus disallowed a basis in the LLC and assessed the Taxpayers on the entire "recaptured" losses that the Taxpayers had previously deducted.

The burden was on the Taxpayers to provide records establishing their correct

liability in the subject years, including records verifying the Taxpayer's basis in the LLC in issue. Code of Ala. 1975, §40-2A-7(a)(1). They failed to do so. Consequently, the Department's disallowance of the Taxpayer's claimed basis in the LLC, and the resulting tax due, is affirmed. Judgment is entered against the Taxpayers for 2005 tax and interest of \$186,706.31. Additional interest is also due from the date the final assessment was entered, March 12, 2009.

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

Entered December 28, 2009.

BILL THOMPSON
Chief Administrative Law Judge

bt:dr

cc: Mark Griffin, Esq.
Harvey J. Cutter, CPA
Tony Griggs