

ROBERT M. & VIRGINIA H. JOHNSON §
3532 SHANDWICK PLACE
BIRMINGHAM, AL 35242, §

STATE OF ALABAMA
DEPARTMENT OF REVENUE
ADMINISTRATIVE LAW DIVISION

Taxpayers, §

DOCKET NO. INC. 10-212

v. §

STATE OF ALABAMA §
DEPARTMENT OF REVENUE.

FINAL ORDER

The Revenue Department assessed Robert M. and Virginia H. Johnson (together “Taxpayers”) for 2005 and 2006 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 26, 2010. CPA Beth Arnett and W. J. Davis represented the Taxpayers. Assistant Counsel Lionel Williams represented the Department.

Robert Johnson (individually “Taxpayer”) owned and operated a business in Birmingham during the years in issue. The business was struggling financially in 2005, and the Taxpayer tentatively agreed to sell the business to a Louisiana company. The business owed various debts that were also personally guaranteed by the Taxpayer. The tentative sales agreement provided that the purchaser would relieve the Taxpayer from personal liability for the company’s debts.

The acquisition was never consummated. Consequently, the Taxpayer was required to personally borrow and otherwise acquire money from various sources to pay his business-related debts. The company survived, and is still operating.

The Taxpayers claimed a business-related loss of almost \$200,000 on their 2005 Alabama return. The loss resulted in a net operating loss (“NOL”) for the year. The Taxpayers subsequently carried the 2005 NOL over to 2006.

The Department reviewed the Taxpayers' 2005 return and determined that the \$200,000 loss claimed on the return could not be allowed because the Department understood that the business that had purchased the Taxpayer's company had agreed to assume the Taxpayer's personal business-related liabilities. A December 15, 2009 letter from the Department to the Taxpayers reads in part – "This agreement states that (Taxpayer) . . . will be released from personal guarantees (for the company's debts). Therefore, your Schedule C expenses have been disallowed based on these facts." The Department also disallowed the Schedule E rental expense deductions on the 2005 return as unsubstantiated.

The Department subsequently entered a 2005 preliminary assessment against the Taxpayers on February 1, 2010 based on the disallowed Schedules C and E deductions. It also assessed the Taxpayers for the 2006 tax in issue because the disallowed 2005 deductions resulted in no NOL carryover available for 2006.

To begin, the 2005 final assessment must be dismissed because the preliminary assessment for that year was not timely entered within three years, as required by Code of Ala. 1975, §40-2A-7(b)(2). That section requires that a preliminary assessment must be entered "within three years from the due date of the return, or three years from the date the return is filed with the department, whichever is later," The Taxpayers' 2005 return was due on April 15, 2006, and according to the Department's records, was filed on May 23, 2006. The Department thus had three years from May 23, 2006, or until May 23, 2009, to enter a preliminary assessment for any tax due. As indicated, the preliminary assessment was not entered until February 1, 2010. The 2005 final assessment is accordingly dismissed.

The remaining issue is whether the Taxpayers incurred an NOL in 2005 that can be carried over to 2006. Although the assessment of the 2005 tax year is barred by the statute of limitations, the Taxpayers' 2005 return can be reviewed to determine if they incurred an NOL in that year that can be carried over and claimed in a subsequent open year, i.e., 2006. See generally, *McAlpine v. State of Alabama, Inc.* 98-432 (Admin. Law Div. 10/26/1999).

The Department disallowed the Schedule C expenses on the 2005 return because the Department understood that the company that was to purchase the Taxpayer's business would assume all of the Taxpayer's business-related liabilities. In that case, the Taxpayer would no longer have been personally liable for the debts of the business, and thus could not have deducted any amounts paid on those debts.

The evidence shows, however, that the sale was never closed, and consequently, the Taxpayer remained personally liable for the businesses' debts. He accordingly paid almost \$200,000 toward those debts in 2005, which resulted in a business-related loss in the year. The Taxpayers thus had a 2005 NOL which they could carry over to 2006. The 2006 final assessment is also dismissed. 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 August 31, 2010.

BILL THOMPSON
Chief Administrative Law Judge

bt:dr

cc: Gwendolyn B. Garner, Esq.
W. J. Davis
Kim Peterson