STATE OF ALABAMA DEPARTMENT OF REVENUE,	§ §	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
v.	§	DOCKET NO. INC. 86-262
CURTIS G. & EDNA L. LOCKETT Route 16 Box 349 Mobile, AL 36619,	§ §	
Taxpayers.	§	

ORDER

The Revenue Department ("Department") assessed income tax against Curtis G. and Edna L. Lockett ("Taxpayers") for the years 1982, 1983 and 1984. The Taxpayers appealed to the Administrative Law Division and a hearing was conducted in the matter on September 24, 1987. Mr. Lockett ("Taxpayer") was present and represented himself and his wife. Assistant counsel Mark Griffin appeared on behalf of the Department. Based on the evidence submitted in the case, the following findings of fact and conclusions of law are hereby made and entered.

FINDINGS OF FACT

The assessments in issue are based on a cash transaction audit of the Taxpayers' 1982, 1983 and 1984 Alabama returns. The audit was performed using the Taxpayers' bank records and business receipts.

For the subject years, the Taxpayers claimed expenses (travel, labor, materials, etc.) incurred in the construction renovation, and/or repair of a house in Marengo County and a house in Birmingham. The Marengo County house was owned by the Taxpayers'

corporation, Center Line Construction, Inc. ("corporation"). Those expenses were disallowed as either contributions to capital of the corporation or non-deductible capital expenditures. The Birmingham house expenses were also disallowed as capital expenditures.

In 1983 and 1984, the Taxpayer worked only on the Marengo County and Birmingham houses. He received no income, but reported what he would have made if he had worked for reasonable wages. The Department allowed only income actually received, per the Taxpayer's records. An overstatement of income in 1982 was also disallowed.

The Taxpayers depreciated a truck and trailer owned by the corporation. Those deductions were disallowed. Other miscellaneous business deductions were also disallowed for lack of substantiation.

The Taxpayer claimed various deductions relating to his personal residence in Mobile. The Taxpayer argued that the residence had been converted and used for rental purposes. However, the deductions were disallowed because no evidence of actual rental or intent to rent was provided.

A $69,600.00 casualty loss was claimed when the Birmingham house was destroyed by fine in 1984. The house had an original basis of $23,535.00. After claiming depreciation of $18,300.00, the basis was reduced to $5,235.00. The receipt of $11,000.00 in insurance from a previous fire further reduced the basis to ($5,765.00) (unrealized gain). Reconstruction expenses of

$39,415.77 increased the basis to $33,650.77. A mortgage of $28,224.21 was forgiven, which again reduced the basis to $5,426.56. Finally, the house was completely destroyed by fire in 1984. Thus, the Department allowed a casualty loss of $5,326.56 (basis of $5,426.56 less $100.00 deductible).

CONCLUSIONS OF LAW

All taxpayers are required to keep accurate and complete books and records, Code of Ala. 1975, §40-1-5(c). In the absence of such records, the Department can compute liability using the best method and information available. U.S. v. Firtel, 446 F.2d 1005. Thus, the Department's use of the indirect audit record was justified because of the Taxpayer's failure to keep complete records.

The primary dispute concerns the deductions claimed on the Birmingham and Marengo County houses. The Marengo County expenses were disallowed because the property was owned by the Taxpayer's corporation. Thus, any expenditures would necessarily go to increase the Taxpayer's capital in the corporation, and would not be currently deductible. Further, the improvements on both properties constituted non-deductible capital expenditures.

Capital expenditures are not currently deductible. Helgerson v. U.S., 426 F.2d 1293. A capital expense has been generally defined as any expenditure paid out for new construction or for permanent or long term repairs, see 26 U.S.C.A. §263. An improvement with a useful life of more than one year is considered

capital in nature. Georator Corporation v. U.S., 485 F.2d 283. An expense must be capitalized if the work involves a "general plan" to rehabilitate, modernize and improve the subject property, even though some of the work, if taken separately, would be currently deductible. Mountain Fuel Supply Company v. U.S., 449 F.2d 816; U.S. v. Wehrli, 400 F.2d 686; Jones v. C.I.R., 242 F.2d 616.

The distinction between deductible repairs and non-deductible capital expenditures was set out in Jones as follows:

> A repair is an expenditure for the purpose of keeping the property in an ordinarily efficient operating condition. It does not add to the value of the property, nor does it appreciably prolong its life. It merely keeps the property in an operating condition over its probable useful life for the uses for which it was acquired. Expenditures for that purpose are distinguishable from those for replacements, alterations, improvements or additions which prolong the life of the property, increase its value, or make it adaptable to a different use. (cites omitted).

The expenses relating to the Marengo County house were incurred when the house was being constructed and later remodeled. Those expenses were clearly non-deductible capital expenditures. The expenses relating to the Birmingham house were also incurred in repairing and converting the property for rental use. That construction was also clearly part of a general plan of capital improvements, and thus the expenses relating thereto were non-deductible.

Various other miscellaneous business deductions were disallowed due to lack of substantiating records. A taxpayer has the burden of proving by adequate evidence his right to a claimed

deduction. <u>Showell v. C.I.R.</u>, 238 F.2d 148. The Taxpayer did provide records concerning the Birmingham and Marengo County properties, but no records were provided relating to expenses on other work projects. Consequently, those claimed deductions were properly disallowed.

A casualty loss under Code of Ala. 1975, §40-18-15(a)(6) is measured by the difference between the value of the property immediately preceding the casualty and its value immediately following, but is limited to the adjusted basis of the property. <u>Helvering v. Owens</u>, 59 S.Ct. 26, 305 U.S. 468; <u>U.S. v. Koshland</u>, 208 F.2d 636.

In the present case the Taxpayer claimed a casualty loss of approximately $70,000.00. However, the basis in the property had been reduced to approximately $5,300.00 by prior depreciation deductions, the receipt of insurance proceeds, and the release of a mortgage on the property. As a result, the allowable casualty loss was properly adjusted downward by the Department.

The above considered, it is hereby determined that the adjustments made by the Department, as discussed above, were proper. Accordingly, the Revenue Department is hereby directed to make final the preliminary assessments in issue, with interest as required by statute.

Done this 17th day of November, 1987.

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BILL THOMPSON
Chief Administrative Law Judge