

STATE OF ALABAMA
DEPARTMENT OF REVENUE,

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STATE OF ALABAMA
DEPARTMENT OF REVENUE
ADMINISTRATIVE LAW DIVISION

§

v.

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DOCKET NO. INC. 88-201

SEYMOUR, JR. & SARA F. WEST
404 6th Street
Jacksonville, AL 33606,

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Taxpayers.

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ORDER

Seymour, Jr. & Sara F. West (Taxpayers) claimed a net operating loss (NOL) for the 1986 tax year and attempted to carry the loss back for refunds in 1983 and 1984. The Department denied the NOL and the Taxpayers appealed to the Administrative Law Division. A hearing was conducted on July 18, 1990. Mr. S. Ben Hebert appeared for the Taxpayers. Assistant counsel Mark Griffin represented the Department. The Administrative Law Judge entered a Recommended Order on September 10, 1990 holding that Taxpayers did not have an NOL in 1986 and the refunds for 1983 and 1984 should be denied. This Order is based on the administrative record and the Recommended Order.

FINDINGS OF FACT

The issue in dispute is whether a stock loss and a bad debt loss Incurred by Seymour West, Jr. (Taxpayer) in 1986 were attributable to the Taxpayer's trade or business for purposes of computing the NOL deduction at Code of Ala. 1975, §40-18-15(a)(16).

If the deductions are "business" related, then they should be allowed in full in computing the NOL and the refunds in issue

should be granted. If the deductions are "nonbusiness", then the limitations of §40-18-15 (a)(16)f.3. come into play and the refunds should be denied. Under subsection f.3., "nonbusiness" deductions can be considered in computing an NOL only up to the amount of nonbusiness income reported by a taxpayer.

The Taxpayer operated a real estate business in Jacksonville, Alabama during the 1980s and also served as a director and on the loan committee of a local bank. The Taxpayer owned stock in the bank and also received approximately \$9,700.00 in director's fees from the bank during the years 1981 through 1984. The director's fees represented approximately 7.5% of the Taxpayer's adjusted gross income for those years.

In 1985, the directors discovered that the bank's president had issued almost \$10,000,000.00. in fraudulent loans. Several of the directors loaned the bank money in an attempt to help the bank out of its financial crisis. The Taxpayer loaned the bank \$25,000.00 and received in return a \$25,000.00 promissory note. The Taxpayer later gave up his \$25,000.00 promissory note and took back a note for \$12,500.00 in a further attempt to save the bank.

The attempted bailout failed and the bank was closed by the FDIC in 1986. The Taxpayer's bank stock became worthless at that time, but the Taxpayer received payment in full on the \$12,500.00 promissory note.

The Taxpayer claimed an NOL in 1986 and attempted to carry the

loss back for a refund to 1983 and 1984. In computing the NOL, the Taxpayer classified the \$12,500.00 loss on the loan to the bank and his loss on the worthless bank stock (the Taxpayer claimed his basis of \$19,280.00) as "business" deductions. As noted if those deductions are derived from the Taxpayer's trade or business, then they can be used in full in computing the NOL under §40-18-15(16).

The Taxpayer argues that his investment in the bank stock allowed him an opportunity to be a director and also on the bank's loan committee. The Taxpayer was compensated for his services as a director and thus contends that his stock ownership was proximately related to his business and should be characterized as a "business" investment.

Concerning the bad debt loss, the Taxpayer maintains that he loaned the money to the bank for the primary purpose of protecting his business reputation and also to protect his income and position as a director of the bank.

The Department argues that the Taxpayer's stock loss cannot be classified as a "business" loss because the Taxpayer was not engaged in business as a stockbroker or trader. The Department further contends that the Taxpayer loaned the bank the \$25,000.00 in issue primarily to protect his stock investment, and not primarily to protect his business reputation or his salary as a director.

CONCLUSIONS OF LAW

"Business" deductions can be allowed in full in computing an NOL. However, §40-18-15(16)(a)f.3. Provides that "nonbusiness" deductions can be allowed only up to the amount of "nonbusiness" income reported by the taxpayer.

For a stock loss to constitute a "business" deduction for purposes of computing an NOL, a taxpayer must be actively engaged as a stockbroker or trader, as opposed to an investor, see Purvis v. C.I.R., 530 F.2d 1332.

In this case the Taxpayer's primary business was real estate and his ownership of the bank stock was clearly an investment. The Taxpayer was not in the business of owning or trading stock. The loss on the bank stock was thus a "nonbusiness" loss subject to the limitations of subsection f.3.

The determining factor in deciding whether a bad debt loss is "business" or "nonbusiness" is whether the transaction had a dominant business motive. A significant business motive is not sufficient, see U. S. v. Generes, 92 S. Ct. 827, 405 U.S. 93.

The Taxpayer argues that he loaned the \$25,000.00 to the bank not to protect his stock investment but primarily to protect his business reputation and also to insure his salary as a director.

However, looking objectively at the dollars involved, the Taxpayer had more to gain by saving his stock investment than by keeping his salary as a director. The Taxpayer's income as a director averaged less than \$2,500.00 per year and only 7.5% of his yearly income,

whereas his stock had a basis of almost *20,000.00 (the fair market value prior to discovery of the fraud in 1985 may have been much greater).

Also, the Taxpayer's real estate business was not directly related to or dependent upon the success of the bank. The Taxpayer may have worried that the bank's failure might reflect unfavorably on his reputation as a prudent business man. However, if the Taxpayer's reputation was damaged at all it was because as a member of the loan committee he unknowingly approved the fraudulent loans made by the bank president. Thus, any damage to the Taxpayers's business reputation occurred when the fraudulent loans were revealed, which was before the Taxpayer loaned the \$25,000.00 to save the bank.

A loan to a corporation by an individual that is both a stockholder and an employee of the corporation is usually motivated by both "business" and "nonbusiness" considerations. U. S. v. Generes, supra, at page 833. The Taxpayer had mixed motives when he loaned the \$25,000.00 to the bank. He wanted to protect both his stock investment and his salary as a director, and he was probably also concerned with his business reputation in the community. However, it cannot be said that the Taxpayer's concern for his real estate business or his desire to maintain his relatively small director's salary were the dominant motives for the loan. Accordingly, the loan must be classified as to non-business" and therefore subject to the subsection f.3. limitations.

The above considered, the Taxpayers did not have an NOL in 1986 and the refunds in issue for 1983 and 1984 should be denied. This is the final order in this action and may be appealed pursuant to Code of Ala. 1975, §41-22-20.

Entered this 17th day of September, 1990.

JAMES M. SIZEMORE, JR., Commissioner