Business Bad Debt vs. Nonbusiness Bad Debt

Cross References

- *Owens,* T.C. Memo. 2017-157, August 10, 2017

The tax ramifications of a bad debt deduction depends on whether it is a business bad debt or a nonbusiness bad debt. A business bad debt is deductible on the business tax return of the taxpayer as an ordinary loss and can generate a net operating loss (NOL). A nonbusiness bad debt is deductible as a short-term capital loss, subject to the $3,000 per year net capital loss limitation.

The taxpayer in this case made a career out of lending money for profit, both through business entities and out of his personal funds. One of his personal loans to a commercial laundry wound up going bad. He deducted the loss as a business bad debt which in turn created NOL carrybacks and carryforwards. The IRS claimed it was a personal bad debt because the taxpayer's private lending was not a trade or business.

IRC section 166 allows a deduction for a bona fide debt that becomes worthless within the tax year. To be treated as a business bad debt, the regulations require that:

- The debt be created or acquired in connection with the taxpayer's trade or business,
- A bona fide debt existed between the taxpayer and his debtor, and
- The debt became worthless in the year the bad debt deduction was claimed.

For a money lending activity to be considered a trade or business, the taxpayer must have been involved in the activity with continuity and regularity, with the primary purpose of earning income or making a profit. The courts have developed a non-exhaustive list of facts and circumstances to consider in deciding whether a taxpayer is in the business of lending money:

- The total number of loans made,
- The time period over which the loans were made,
- The adequacy and nature of the taxpayer's records,
- Whether the loan activities were kept separate and apart from the taxpayer's other activities,
- Whether the taxpayer sought out the lending business,
- The amount of time and effort expended in the lending activity, and
- The relationship between the taxpayer and his debtors.

The IRS argued that even if the taxpayer had made enough loans over the years, his source of funds was a family limited partnership (FLP) he managed with his two sisters. Out of 89 loans made over a 14 year period, only 8 listed the taxpayer as the lender. The rest listed the FLP as the lender.

The court disagreed with the IRS in that the majority of those alleged to be FLP loans were in fact made from the taxpayer's personal trust. The taxpayer made at least 66 loans over this period of time (either alone, or acting as trustee of his trust) to a multitude of borrowers, easily exceeding $24 million. These figures were more than sufficient to support the finding that the taxpayer's personal lending activities were continuous and regular by themselves.

The IRS pointed out that the taxpayer's records were maintained by employees of his family business and not by him personally. The court did not see how this should count against the taxpayer. The family business was a lending company and its employees knew the business. Using the family lending company's office space and employees for the service of his personal loans was entirely consistent with the taxpayer being in the trade or business of lending money.

The IRS also argued that the taxpayer failed to prove how much time he spent making personal loans. The taxpayer testified that he generally spent an average of 50 hours at work each week and did not distinguish the time he spent on lending from his personal funds from the time he spent lending through his family business. The court noted this is a factor to be considered. But it also said the toilsome drudgery of measuring out one's days in six-minute increments is rarely found among our more entrepreneurial countrymen. They are more inclined to focus on getting the chore in front of them done as efficiently as possible, than on keeping detailed time sheets. The court said the taxpayer had no need to bill specific hours on his personal lending while managing his family business. Unless motivated by some hidden whimsy or charitable purpose, the number of personal loans made and the money he tied up in them proves he spent a sufficient amount of time on them.

The IRS also argued that the taxpayer did not advertise his availability to make personal loans. The court agreed, but said he didn't need to. He had a reputation in the community as a lender and was very well respected. It was not unusual for borrowers to call the family business and ask for the taxpayer directly.

The IRS also questioned a loan that went bad where the taxpayer continued to lend money to the borrower. The court said it is easy in hindsight to argue that lending money to a borrower who ultimately fails is unreasonable. Taxpayers continue to lend money to a borrower over time because they see it as the only way to fully recoup their investment. Advancing more and more money to a growing and capital intensive business was reasonable under the circumstances. It turned out to be a bad business decision, but it was a business decision and not charity or lunacy or something else.

The court ruled the taxpayer lent from his personal funds continuously and regularly and did so with the purpose of making a profit. He was therefore in the trade or business of lending money.