Tax Impact

May/June 2024

Bad debt deduction
When debt is really equity

Handle your estate planning documents with care

Charitable gift annuities: A versatile planning tool

Tax Tips

Bad debt deduction

When debt is really equity

The tax code allows you to claim a deduction for business debts that have become worthless. But qualifying for the deduction may be more complicated than you think.

In a recent case, the IRS denied more than $17 million in bad debt deductions on the grounds that the advances in question represented equity rather than debt, hitting the taxpayer with millions of dollars in taxes and penalties. The U.S. Tax Court, in *Allen v. Commissioner*, sided with the IRS.

When is the deduction available?

The bad debt deduction is valuable because you can use it to reduce ordinary income. But keep in mind that it's available only for *business* bad debts. Nonbusiness bad debts (for example, from personal loans) generate capital losses, which can be used only to offset capital gains plus up to $3,000 in ordinary income.

Generally speaking, a bad debt deduction is available if 1) you hold a bona fide debt, 2) the debt instrument or documentation isn't a security, and 3) the debt has become worthless — that is, there's no reasonable expectation of payment. If a debt has become *partially* worthless, you may be able to deduct the portion of the debt that's uncollectible, but only if you've charged it off for accounting purposes during the tax year.

Debt or equity?

In *Allen*, the IRS and Tax Court agreed that the taxpayer's bad debt deduction failed to meet the first requirement listed above. That's because the worthless "loans" in the case represented equity rather than bona fide debt.

The taxpayer managed a real estate enterprise made up of several companies that he owned or controlled. In the tax years under review, he caused certain entities within his enterprise to advance millions of dollars to various related entities. The taxpayer argued that the advances were intended as bona fide loans. But the IRS determined that his "business purpose was to infuse capital into recipient companies and then redistribute those funds to himself and his related business entities as equity."

To determine whether the advances were debt or equity, the Tax Court analyzed 13 factors as set forth in a prior case:

1. Names given to the certificates evidencing indebtedness,
2. Presence or absence of a fixed maturity date,

Want to avoid penalties? Show good faith

In *Allen v. Commissioner* (see main article), the U.S. Tax Court upheld the IRS's imposition of significant underpayment penalties: 20% of the amount by which taxes were underpaid. Taxpayers can avoid these penalties by showing that they acted with reasonable cause and in good faith.

In determining the existence of reasonable cause and good faith, courts look at a taxpayer's experience, education and sophistication, among other factors. They also place significant emphasis on the taxpayer's efforts to assess the proper tax liability, including reasonable, good-faith reliance on professional advice. In *Allen*, there was no evidence that the taxpayer sought professional advice when he determined that the "loans" were worthless or took any other steps to assess the proper tax liability.

3. Source of principal payments,
4. Right to enforce payment of principal and interest,
5. Participation in management,
6. Status of the contribution in relation to regular corporate creditors,
7. Intent of the parties,
8. Thin or adequate capitalization,
9. Identity of interest between creditor and stockholder,
10. Source of interest payments,
11. Ability of the company to obtain loans from outside lending institutions,
12. Extent to which the advance was used to acquire capital assets, and
13. Failure of the debtor to repay on the due date or seek a postponement.

No single factor is controlling, and the factors aren't necessarily weighted equally. Rather, the court considers each factor in the context of the specific facts and circumstances of the case.

Tax Court findings

In this case, the court found that seven of the factors (3, 4, 7, 8, 9, 10 and 11) favored equity, three (1, 2, and 5) favored debt and three (6, 12 and 13) were neutral. The court acknowledged that the purported loans were evidenced by promissory notes that identified fixed maturity dates, and that the taxpayer's participation in management didn't increase by virtue of the advances.

But several factors supported the conclusion that the advances were, in substance, equity infusions:

- Repayment of the advances was dependent on the recipients' sales.
- Although the taxpayer had a contractual right to enforce payment, the recipients had no ability to repay the debts. So, in substance, there was no right to enforce payment.
- There was no real expectation of payment, evidenced by a complete lack of interest payments and the fact that the taxpayer continued to make advances even after claiming bad debt deductions.
- The recipients were thinly capitalized when they received the advances.

- The interests of the purported lenders and borrowers were "significantly intertwined."
- The lack of interest payments indicated that the purported lenders were "not expecting substantial interest income and, instead, [were] more interested in future earnings."
- The recipients weren't creditworthy at the time the advances were made and would have had trouble obtaining loans from outside lenders.

Takeaways

The *Allen* case is instructive for taxpayers hoping to ensure that advances (particularly to related parties) are treated as debt rather than equity. Executing appropriate loan documentation is important, but it's not enough. It's also critical that the borrower is creditworthy and sufficiently well capitalized to support a realistic expectation of repayment, and that the parties treat the transaction like a loan. ■

Handle your estate planning documents with care

If you were to unexpectedly die, would your family know where to find and access your estate planning documents? If not, you need to take the steps to ensure that they're informed. Otherwise, your well-laid plans can be derailed.

Focus on your will

There's a common misconception that a photocopy of your signed last will and testament is sufficient. In fact, when it comes time to implement your plan, your family and representatives will need a signed original will to accomplish that purpose. Typically, the original document will need to be filed with the county clerk and, if probate is required, with the probate court as well.

What happens if your original will isn't found? It doesn't necessarily mean that your will won't be given effect, but it can be a big — and costly — obstacle.

In many states, if your original will can't be produced, there's a presumption that you destroyed it with the intent to revoke it. Your family may be able to obtain a court order admitting a signed photocopy, especially if all interested parties agree that it reflects your wishes. But this can be a costly, time-consuming process. And if the copy isn't accepted, the probate court will administer your estate as if you died without a will.

Consider different storage options

To avoid these issues, be sure that your original will is stored in a safe place and that your family knows how to access it.

Storage options include:

- Leaving your original will with your accountant, attorney or another trusted advisor and ensuring that your family knows how to contact him or her.
- Storing your original will at home (or at the home of a trusted family member) in a waterproof, fire-resistant safe, lockbox or file cabinet and ensuring that trusted family members know the combination or have access to the keys.

In many states, it can be difficult for loved ones to open your safe deposit box, even with a valid power of attorney. It may be preferable, therefore, to keep your original will at home or with a trusted advisor or family member. If you opt for a safe deposit box, it may be a good idea to open one jointly with your spouse or another trusted family member. That way, the joint owner can immediately access the box in the event of your death or incapacity.

Provide photocopies

Original trust documents should be kept in the same place as your original will. It's also a good idea to make several copies. Unlike a will, it's possible to use a photocopy of a trust. Plus, it's useful to provide a copy to the person who will become trustee and to keep a copy to consult periodically to ensure that the trust continues to meet your needs.

For powers of attorney, living wills or health care directives, originals should be stored safely. But it's also critical for these documents to be readily accessible in the event you become incapacitated. So, for example, you might want to avoid keeping these documents in a safe deposit box, where they won't be accessible outside of banking hours.

Consider giving copies or duplicate originals to the people authorized to make decisions on your behalf. Also consider providing copies or duplicate originals of health care documents to your physicians to keep with your medical records.

Destroy outdated files

Anytime you revise your estate plan, be sure to shred the old document. The last thing you want to happen is for your loved ones to be unsure which is the latest document. Contact your estate planning advisor to ensure you've covered all the bases and all your documents are updated, based on your current situation. ■

Charitable gift annuities: A versatile planning tool

If you're charitably inclined, a charitable gift annuity allows you to donate to charity while enjoying significant tax breaks and a lifetime income stream. And if you're age 70½ or older, you can now transfer up to $53,000 ($106,000 for married couples) to a charitable gift annuity directly from an IRA and apply the gift toward your required minimum distributions (RMDs) for the year.

How it works

To take advantage of a charitable gift annuity, you donate cash, stock or other assets to one or more qualified charities in exchange for a guaranteed fixed income stream for life. You'll enjoy an immediate tax deduction (subject to IRS limits) equal to the amount of your donation minus the present value of the annuity.

Typically, annuity rates are based on rates suggested by the American Council on Gift Annuities (ACGA). For example, in 2024, the ACGA recommends a rate of 5.2% for a 60-year-old recipient, 6.3% for a 70-year-old recipient and 8.1% for an 80-year-old recipient. Lower rates apply if you designate two recipients, such as you and your spouse, as joint-and-survivor annuitants. These rates are typically lower than rates on commercial annuities because charitable gift annuities are designed to preserve a significant portion of your donation for the charity.

For income tax purposes, annuity payments generally are treated as a combination of ordinary income and tax-free return of principal. If you donate appreciated property in exchange for the annuity, a portion of the payments will be taxed as capital gains.

Donating funds from an IRA

If you're 70½ or older, you're currently permitted to make qualified charitable distributions (QCDs), up to an inflation-adjusted $100,000 per year, directly from an IRA to a qualified public charity. For 2024, the limit is $105,000. QCDs aren't tax deductible, but unlike other IRA distributions they're not included in your adjusted gross income, resulting in significant tax savings. Plus, QCDs apply toward any RMDs for the year.

Now, under the SECURE 2.0 Act, you can transfer a portion ($53,000 in 2024) of your annual QCD limit to a charitable gift annuity. In addition to current tax savings, these annuities can generate a significant income stream for life (taxable as ordinary income).

But there are a couple of caveats: Unlike regular QCDs, which can be done once a year, transfers from an IRA to a charitable gift annuity are a once-in-a-lifetime proposition. Although you can split the $53,000 limit among several charitable gift annuities in a single tax year, any portion of the limit left unused at the end of the year is lost. Also, these annuities are required to pay out at a rate of at least 5%. That's currently not a problem unless you're under age 59, because the ACGA's recommended rates for anyone who's older than 58 are above 5%. But it could create issues in the future if the recommended rates fall below that threshold.

To take advantage of a charitable gift annuity, you donate cash, stock or other assets to one or more qualified charities in exchange for a guaranteed fixed income stream for life.

Evaluate charities carefully

Charitable gift annuities — whether funded by an IRA or other assets — can be an effective tool for satisfying your charitable goals while providing financial benefits for you (and your spouse if you're married). Keep in mind, however, that the promise of lifetime income is only as good as the financial strength and stability of the charitable organization backing it up. So be sure to do your due diligence on the charities obligated to make the annuity payments. ■

Interested in LTC insurance? Consider a tax-free exchange

Long-term care (LTC) insurance can help cover the expenses if you or a loved one requires an extended stay at a nursing home or assisted facility or other long-term health care. One option for financing LTC insurance is to use a tax-free Section 1035 exchange.

An exchange allows you to transfer the cash value of a life insurance policy or annuity directly to a new LTC policy, without triggering a taxable distribution. Typically, partial exchanges are used to fund annual premium obligations, but it's also possible to use a complete exchange to trade a life insurance policy or annuity for an LTC policy or a hybrid LTC/life insurance policy. ■

Used clean vehicle tax credit: Handle with care

You're probably familiar with the $7,500 federal tax credit for purchases of certain *new* electric, plug-in hybrid and fuel-cell vehicles. But did you know that there's a tax credit available for *used* clean vehicles? It's equal to 30% of the sale price, up to a maximum credit of $4,000. However, strict rules about which vehicles are eligible may make it difficult for many people to qualify for the credit.

To qualify, a vehicle must have a sale price of $25,000 or less, a model year at least two years earlier than the year you buy it, not already have been resold after August 16, 2022, and be purchased from a dealer, along with certain other technical requirements. Also, to be eligible for the credit, you must not have claimed another used clean vehicle credit in the preceding three years, and your modified adjusted gross income must not exceed $75,000 for single filers ($150,000 for joint filers). Note that these income limits are half the size of those for the new clean vehicle credit. ■

Should you hire your kids?

If you own a business, consider hiring your children for the summer or even part-time while school is in session. Hiring your kids may provide tax benefits, assuming you have age-appropriate work for them to do.

For example, if your children are under 18 and your business is unincorporated, neither the business nor the kids have to pay Social Security or Medicare taxes. Plus, because wages are deductible, this strategy may reduce your family's tax liability by shifting some income to your children who will be in a lower tax bracket. In fact, kids won't have to pay any taxes if their income doesn't exceed the standard deduction ($14,600 in 2024). ■

This publication is distributed with the understanding that the author, publisher and distributor are not rendering legal, accounting or other professional advice or opinions on specific facts or matters, and, accordingly, assume no liability whatsoever in connection with its use. ©2024