

DISCUSSION

First issue – Whether the nonbusiness bad debt rules apply to the \$380,000 loss incurred by the Petitioner, from a loan to the [Redacted]. Treasury Regulation 1.166-5 defines and gives examples of nonbusiness bad debt. Two main tests from that regulation are;

- a. Whether the Petitioner was actively involved in a trade or business at the time the loan was made and;
- b. Whether the loan was made in proximity to that business.

A nonbusiness loss is subject to the limitations provided in section 1211, relating to the limitation on capital losses (limited to \$3,000 after being netted with capital gains), and section 1212, relating to the capital loss carryover, and in the regulations under those sections.

PETITIONER’S POSITION:

The Petitioner’s position is that he made a loan as a business loan to the [Redacted] and, therefore, the loss should be treated as an ordinary loss. The Petitioner offers his experience working with an automobile dealer trading in specialty cars that are difficult to value and obtain financing. The Petitioner formed [Redacted] in the State of [Redacted], with another partner in part, to lend money to buyers of these specialty cars. [Redacted] also owns some commercial real estate. In the protest letter the attorney stated “[Redacted] estimates that he made approximately 900 such loans during his 8 years with the automobile dealership. After “retiring” he made an additional 350+ loans.”

The Petitioner moved to Idaho in 2006 and acquired a commercial rental property located in [Redacted], Idaho. The Petitioner created [Redacted] to hold and operate the rental property. The [Redacted] loan was made by [Redacted]. The Petitioner did not offer any new evidence that he has an active trade or business loaning money. The activity of the Idaho commercial

property is reported as rental real estate on Schedule E of the Petitioner's individual income tax return. The Petitioner's tax returns report the K-1 income from [Redacted] as passive income on Schedule E. At the informal hearing, the Petitioner offered a copy of a list of receivables for [Redacted] as evidence that he has a long history of lending money primarily associated with automobiles. The Petitioner has not reported any business activity as an individual since filing individual income tax returns in Idaho. There is no evidence that this loan to [Redacted] has any connection to [Redacted] or the Petitioner's prior automobile selling activity.

[Redacted] is a partnership operating exclusively in [Redacted]. It does not do business or file partnership returns in Idaho. On the [Redacted] partnership returns of [Redacted], it reports rental real estate as its principal business activity. [Redacted] owns a commercial rental property located in [Redacted] and provides financing for classic autos. The Petitioner claims that even though he retired from the business and no longer lives in [Redacted], he is actively involved in the decision making of [Redacted] was not involved in the [Redacted] loan and does not hold the note.

LAW AND ANALYSIS

Treasury Regulation 1.166-1(c) says in part;

“Bona fide debt required. Only a bona fide debt qualifies for purposes of Internal Revenue Code Section 166, Bad Debts. A bona fide debt is a debt which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money. A debt arising out of the receivables of an accrual method taxpayer is deemed to be an enforceable obligation for purposes of the preceding sentence to the extent that the income such debt represents have been included in the return of income for the year for which the deduction as a bad debt is claimed or for a prior taxable year...”

There is no dispute regarding the existence of a “bone fide” loan, evidenced by a written promissory note with a stated rate of interest.

Internal Revenue Code Section 172(d)(4)

“Nonbusiness deductions of taxpayers other than corporations. In the case of a taxpayer other than a corporation, the deductions allowable by this chapter which are not attributable to a taxpayer’s trade or business shall be allowed only to the extent of the amount of the gross income not derived from such trade or business.”

If a loan is nonbusiness, any loss is treated as a short-term capital loss.

Treasury Regulation 1.461-5(a);

“If the interest of the lender is predominantly that of an investor, the debt will be characterized as a nonbusiness bad debt, because management of one’s own investments, no matter how extensive, does not constitute a trade or business.”¹

Idaho Tax Commission Administration and Enforcement Rule 200.01 states in part;

“In General. a. A taxpayer shall maintain all records that are necessary to a determination of the correct tax liability. Required records must be made available on request by the Tax Commission or its authorized representatives...”

The case law is well developed on the question of what is a business or a nonbusiness bad debt.

“We do not find that the making of eight or nine loans in the course of a 4-year period elevates that activity to the status of a separate business.”²

AUDIT POSITION:

The NODD cited three cases that provide guidance on the requirement of the regulations.

First, a Tax Court memo, Merante³, the court said;

“where it is unclear whether the lender was engaged in any trade or business at the time of making a loan, the loan had to be treated as a nonbusiness debt.”

Second, in Generes⁴ the court said

“in determining whether a bad debt has a “proximate” relation to the taxpayer’s trade or business, as the Regulations specify, and thus qualifies as a business bad debt, the proper measure is that of dominant motivation, and that only significant motivation is not sufficient...”

And the third case cited by Audit was Higgins v. Commissioner⁵. In Higgins the court said;

¹ Higgins v. Commissioner, 312 U.S. 212, 218 (1941).

² Imel v. Commissioner, 61 T.C. 318

³ Merante, Douglas v. (1995) TC Memo 2995-522.

⁴ United States v. Generes, 405 U.S. 93, 103(29 AFTR 2d 72-609).

“If the interest of the lender is predominantly that of an investor, the debt will be characterized as a nonbusiness bad debt because management of one’s own investments, no matter how extensive, does not constitute a trade or business.”

The audit analyzed the activities of the Petitioner using some standards developed by the courts to see if there is an active business. This is a portion of the NODD “Explanation of Items”:

“To determine if [Redacted], as an individual, is in the trade or business of lending money, there are several factors that have to be considered. Therefore, we have applied [Redacted] facts and circumstances to the following factors.

1. The number of loans made by the taxpayer over the years.

Documentation was not provided to support that [Redacted] has made other loans. Other than the [Redacted] bad debt claimed in 2011, [Redacted] individual income tax returns do not report lending activity. Therefore, we determined that the [Redacted] loan is the only loan made by [Redacted] as an individual since establishing Idaho residency.

2. The maintenance of an office for engaging in the lending business.

[Redacted] does not have an office used solely for a lending business.

3. The maintenance of books detailing taxpayer’s lending activity.

Unknown. [Redacted] did not provide documentation in support of maintaining separate books and records of a lending business.

4. Whether the taxpayer held himself out to the public to be in the lending business.

[Redacted] did not provide documentation to support that he held himself out to the public as being in the lending business. We did not find information or evidence that [Redacted] was in the lending business.

5. Whether the taxpayer advertised his loan services.

We did not find advertising for a lending business.

6. Whether the taxpayer had a reputation in the community for making loans.

⁵ 312 U.S. 212, 218 (25 AFTR 1160).

Since we do not have evidence that [Redacted] held himself out to the public to be in the lending business, we have determined that he had no reputation in the community as a lender.

7. The amount of income the taxpayer derived from his lending activities.

No income from lending activity can be identified on any of [Redacted] prior year individual income tax returns since establishing Idaho residency. It appears that their business related income is from the Idaho commercial rental or flow-through income from [Redacted].

8. Whether the taxpayer indicated on his return that he was in the lending business.

Lending activity has not been indicated on [Redacted] individual income tax returns prior to the [Redacted] bad debt loss.

9. Whether the loan activities were kept separate and apart from taxpayer's other activities.

Unknown. [Redacted] did not provide documentation in support of maintaining separate books and records of a lending business.

10. The amount of time and effort expended in the lending activity.

Since we have determined that [Redacted] held only one loan, we assume he expended minimal time and effort in lending activity.

11. The relationship between the taxpayer and his debtors.

There is no evidence that [Redacted] had a relationship with his debtor in the [Redacted] loan. The transaction appeared to be an investment opportunity.

12. Whether the primary purpose for the loans was to make a profit from interest and loan related fees.

Loan documents were not provided; therefore, the primary purpose or profit making potential was not made known.

Based upon applying the facts and circumstances to the foregoing factors, it appears that [Redacted] was not in the trade or business of lending money at the time he made the [Redacted] loan."

The Internal Revenue Code and the Treasury Regulations are very clear about the requirements for taking a "Bad Debt" deduction. One of the essential requirements is that there

is a valid and enforceable obligation to pay. In addition, the Idaho Tax Administration Rules are clear about the recordkeeping requirements. The Petitioner explained at the hearing that other than the note there were no other records. The borrower “[Redacted]” did not make any payments.

The Petitioner cited several legal cases to make their points. There were serious distinctions between the facts of those cases and the present case. For example, the definition of a “Trade or Business” in Folker v. Johnson, 230 F.2d 906,907 (2nd Cir 1956), the taxpayer in that case made loans to protect the salary from his wholly owned corporation. In Pierce v. United States, 254 F.2d 885, 887(9th Cir. 1958) the question again was whether the taxpayer’s salaries (husband’s & wife’s) for managing their own corporation. The Petitioner in this case has little in common with either of these cases.

The case that the Petitioner cited the most was a Tax Court Memo Scallen v. Commissioner, T.C. Memo. 2002-294 (2002). Select portions of that case were quoted to make several minor points. Interestingly, Mr. Scallen had a stronger set of facts than our Petitioner to support a finding of a business loss and the Tax Court still found against him.

One point the Scallen case was cited for was whether the method of reporting an activity was conclusive, especially when the tax returns are prepared by a CPA⁶. While Mr. Scallen did not prepare a Schedule C to report the loan guarantee activity, he had some activity over a number of years. In the present case, there was only one loan made and no payments received. There was no activity to report.

DID THE PETITIONER HAVE AN ACTIVE LOAN BUSINESS

The protest letter stated that [Redacted] was retired, and in the follow-up letter it is stated that “we do not consider [Redacted] lending activities a separate trade or business.” The

⁶ Ruppel v. Commissioner, T.C. Memo, 1987-248.

Petitioner is asking us to ignore the limited liability structure of [Redacted] and blend his prior experience with [Redacted] with his current activity. The income from [Redacted] is reported to our Petitioner as passive income. Internal Revenue Code 469 defines a passive activity.

IRC 469(c) Passive activity defined. For purposes of this section -

- (1) In general, The term “passive activity” means any activity -
 - (A) which involves the conduct of any trade or business, and
 - (B) in which the taxpayer does not materially participate.

The Petitioner stated that he had retired. The activity of [Redacted] is reported as though the Petitioner does not materially participate in the business.

There are privileges and responsibilities associated with selecting a business structure. Idaho Code section 30-6-104(1) of the Idaho Uniform Limited Liability Company Act says “A limited liability company is an entity distinct from its members.” The Commission is bound to respect the LLC entity and treat that as distinct from an individual.

The Petitioner offers several examples of court cases where the volume and number of loans is indicative, along with other factors, of a trade or business⁷. As for the frequency and number of loans [Redacted] made, there was only one and, as the Petitioner asserts, there were never any payments made on that loan.

In the Scallen case, Mr. Scallen made several loan guarantees over more than a decade, and when he claimed business bad debt losses during a subsequent four year period, the [Redacted] found that he did not have enough business activity. The Tax Court agreed, even though it was a great deal more than what our Petitioner has in the present case.

⁷ Scallen v. Commissioner, T.C. Memo. 2002-294 (2002)
Cushman v. United States, 148 F.Supp. 880 (D. Ariz. 1956)
Serot v. Commissioner, T.C. Memo. 1994-532
Ruppel v. Commissioner, T.C. Memo. 1987-248
Minkoff v. Commissioner, T.C. Memo. 1956-269

PROXIMITY

Since we have not found evidence that the Petitioner had an active business of lending money, there cannot be sufficient proximity to that. The Petitioner's ownership and prior experience with [Redacted] has no apparent connection with the [Redacted] loan.

DUTY OF CONSISTENCY

Second issue – The Petitioner suggests that the Commission has an obligation to treat the losses in the same manner as the income from his auto loans. There is no evidence that the Commission had ever looked at the Petitioner's tax returns, or was aware of how any of the Petitioner's income was reported, until he filed an amended return asking for a refund based on an unusually large expense when there was no prior evidence that a business existed.

In the Position Paper submitted after the informal hearing was held, the attorney concluded the argument on Consistency as follows:

“In this respect, [Redacted] reports all of the income from his auto loans as “ordinary income.” As stated in Syer, supra, and agreed to in principle by the Tax Court in Dages, supra, it is only equitable that the [Redacted] loss be treated in the same manner as the income would have been...” ordinary.”

“In conclusion, there is no question that [Redacted] engages in the trade or business of buying and selling automobiles. In connection with this business, [Redacted] extends financing. In this context then, [Redacted] loaned money to [Redacted]. And, had the loan been paid off, then the income would have been taxed as “ordinary income.” Therefore, it is both equitable and consistent to treat the loss from the [Redacted] loan as an ordinary loss.”

More importantly, there is no “Duty of Consistency” on a government agency in the administration of the law. The Commission is not bound by a quasi-contract that it is not a party to.

“In levy and imposition of taxes, state acts in its sovereign capacity, and hence in an action for collection of taxes cannot be subjected to equitable estoppel.”⁸

“The government is not estopped by previous acts or conduct of its agents with reference to determination of tax liabilities or by failure to collect the tax, nor will mistakes or misinformation of its officers estop it from collecting the tax.” *Adams, supra.*

“Ultimately, statutes, regulations and judicial decisions govern a taxpayer’s tax liability⁹.

SETTLEMENT OFFER

In the “Position Paper” sent to the Commission subsequent to the informal hearing, the Petitioner offered to settle this case by forgoing the NOL carryback to 2009. However, they request using the loss to offset income in 2010, 2011, 2012, and 2013, then waiving any balance remaining. Since the facts so strongly support the audit, the Commission is not inclined to settle this case.

CONCLUSION

1. There is no evidence that the Petitioner was actively involved in a trade or business as an individual. [Redacted], that made the loan, owns and manages a rental property and made one loan that we are aware of. The loan made to [Redacted] was made as a personal capital investment.

2. The Petitioner did not establish a duty of consistency. There is no evidence that the Commission was aware of the Petitioner’s filing method or alleged business activities. Further, the Commission “cannot be subjected to equitable estoppel.” *Adams, supra.*

THEREFORE, the Notice of Deficiency Determination dated August 20, 2012, and directed to [Redacted] is AFFIRMED by this decision.

⁸ State of Idaho v Adams, 90 Idaho 195, 409 P.2d 415

⁹ Richmond v Commissioner, T.C. Memo. 2009-207

IT IS ORDERED that the Petitioners pay the following tax, penalty, and interest:

<u>YEAR</u>	<u>TAX</u>	<u>PENALTY</u>	<u>INTEREST</u>	<u>TOTAL</u>
12/31/2009	7,114	0	282	7,396
12/31/2011	5,600	0	270	<u>5,870</u>
			Less Payments	<u>(7,442)</u>
				<u>\$5,824</u>

The Commission updated the interest through August 31, 2013, on the Petitioners' tax liability.

DEMAND for immediate payment of the foregoing amount is hereby made and given.

An explanation of the Petitioners' right to appeal this decision is enclosed.

DATED this _____ day of _____ 2013.

IDAHO STATE TAX COMMISSION

COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this _____ day of _____ 2013, a copy of the within and foregoing DECISION was served by sending the same by United States mail, postage prepaid, in an envelope addressed to:

[Redacted]

Receipt No.
