Land Grant University
Tax Education Foundation

2024
NATIONAL INCOME TAX WORKBOOK

# Chapter 7: Business Tax Issues

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## CHAPTER ISSUES
P 225

| | | | |
|---|---|---|---|
| Conditional or Contingent Debt Obligations | Business Bad-Debt Deduction | ~~Fringe Benefits for Small Business~~ | ~~MI Earned Sick Time Act~~ |
| ~~Employer-Provided Child Care Credit~~ | ~~Deduction for Employer-Provided Meals & Entertainment~~ | ~~Marijuana & other Illegal Businesses~~ | ~~Qualified Commercial Clean Vehicles Credit~~ |

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## LEARNING OBJECTIVES P 225

- Determine when a taxpayer can deduct interest on indebtedness that is conditional or contingent
- Calculate gain on a contingent payment installment sale
- Know when a taxpayer can claim a business bad-debt deduction
- Recognize fringe benefits that an employer may exclude from an employee's income
- Understand the eligibility requirements for the employer-provided child care credit
- Know when a deduction for employer- provided meals and entertainment is allowed
- Understand the limits on deducting meal and entertainment expenses and exceptions to those limits
- Understand how a marijuana business reports its expenses
- Know how to calculate the qualified commercial clean vehicles credit

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ISSUE 1

Conditional or Contingent Debt Oblications

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INTEREST DEDUCTION P 227

- I.R.C. § 163(a) -- deducting certain interest paid or accrued on indebtedness within the tax year.
  - Unconditional, and legally enforceable obligation for payment
  - A fixed or determinable maturity
  - The right to enforce payment if there is a default.

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CROSS-REFERENCE: DEBT OR CAPITAL CONTRIBUTION P 227

- The taxpayer has the burden of proof
- Debt and not a contribution to capital
- Debt if:

(1) whether a note or other evidence of indebtedness exists;

(2) whether interest is charged;

(3) whether there is a fixed maturity date or schedule for repayments;

(4) whether any security or collateral is requested;

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CROSS-REFERENCE: DEBT OR CAPITAL CONTRIBUTION
P 227

(5) whether there is any written loan agreement;

(6) whether a demand for repayment has been made;

(7) whether any repayments have been made;

(8) whether the parties' records, if any, reflect the transaction as a loan; and

(9) whether the borrower was solvent at the time of the loan

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CONTINGENT DEBT
P 227

- Conditions Precedent
  - Debt contingent upon future event
  - Valid only after the event occurs
    - The contingency may necessitate a price adjustment or other change in terms.
    - Installment sale method may condition the purchase price on future profit or other conditions that are not currently ascertainable.

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- Guardian was a real estate investment corporation that also financed the sale of single-family homes.
- Guardian borrowed money as a second mortgage.
- No payments of principal and interest were due on the second mortgage note until the first mortgage note was paid in full.
- Guardian accrued and deducted the interest on the second mortgage note.

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### GUARDIAN INVESTMENT CORP. V PHINNEY, 253 F.2d 326 (5TH Cir.1958) P 227

- The IRS disallowed the deduction, taking the position that the interest was not accruable because the taxpayer's liability on the second mortgage note was contingent
- Interest on the 2nd mortgage – No for accrued interest on an indebtedness
  - Must be definite, fixed, and existing in the tax year of deduction
- A contingent obligation may be a liability, but it is not a debt

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### GUARDIAN INVESTMENT CORP. V PHINNEY, 253 F.2d 326 (5TH Cir.1958) P 227

**Elements of Contingency:**

- There was no fixed or determinable maturity date.
- The principal and interest were owed and payable only on the happening of a condition precedent, the prior payment of the first mortgage.
- The happening of the condition precedent was uncertain.
- The condition precedent was a future condition, the occurrence of which did not take place within the tax years in question.
- There was no fixed or determinable liability on the taxpayer's part because if the proceeds from the sale of the mortgaged property were not sufficient to pay off the first mortgage, the taxpayer was not under any obligation to pay any interest or principal of the second mortgage.

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### GUARDIAN INVESTMENT CORP. V PHINNEY, 253 F.2d 326 (5TH Cir.1958) P 227

- Taxpayer was not under any obligation to pay any interest or principal of 2nd mortgage.
- The liability was not an indebtedness on which interest could be accrued and deducted.
- Practitioner Note – State Statute of Limitations
  - First National v. Commissioner

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## COMPLETED SALE - CONDITIONS P 228

Adjustment in the purchase price or other terms, or a rescission of the transaction,

Does not prevent a sale or exchange from being closed for tax purposes.

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## COMPLETED SALE - REPOSSESSION P 228

***Enyart v. Commissioner*, T.C. Memo. 2000-90**

- Sale of corporate stock
- Part of the sale price was paid for with equipment that was subject to liens on the equipment's value.
- The buyer had the right to use the equipment but had no ownership until the liens were paid.
- The seller paid off the liens that encumbered the equipment.

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## COMPLETED SALE - REPOSSESSION P 228

- The seller reported the equipment sale as an installment sale
- The IRS determined that the entire value of the equipment must be included in income in the year of the sale.
- There was nothing in the record to support the seller's contention that its dire financial position indicated a realistic possibility of repossession, and the seller timely made payments on the note.
- Title to the equipment transferred to the buyer, and the possibility of a repossession after the transfer did not defeat the sale.

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## CONTINGENT ON GOVERNMENTAL APPROVAL P 228

***Herbert J. Investment Corporation v. U.S.*, 500 F.2d 44 (7th Cir. 1974)**

- An interstate trucking company
- Sold substantially all its assets to another trucking company.
- The proposed sale required Interstate Commerce Commission (ICC) approval.
- Need permission from the ICC for the buyer to assume temporary control of the assets pending the ICC's final approval.
- The ICC granted temporary authority on April 1 and the buyer took control of the assets.
- On August 30, the ICC granted final approval of the sale, and title was transferred, and the purchase price was paid.

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## *HERBERT J. INVESTMENT CORPORATION V. U.S.* -- CONTINUED P 228

- Buyer's stock value appreciated between the temporary authority date and the final authority date.
- The seller valued those shares as of the temporary authority date (the lower value, which resulted in less gain on the sale)
- The IRS valued those shares as of the final authority date.

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## *HERBERT J. INVESTMENT CORPORATION V. U.S.* – CONTINUED P 228-229

- The court agreed that the temporary sale date was the operative valuation date.
- The assets exchanged were valued as of the temporary sale date
- The agreement fixed their obligations and benefits as of the date of assumption of temporary control, subject only to the contingency of a failure to acquire final approval.
- A sale may be completed for tax purposes despite the existence of future contingencies.
- The court concluded that the temporary approval date was the final sale date.

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## CONTINGENT PAYMENT INSTALLMENT SALE P 229

- Treas. Reg. § 15a.453-1(c)
- An installment sale in which the total sale price cannot be determined by the end of the tax year of the sale.
- Taxpayer sells a business & the sale price includes a percentage of future-year profits.
- Can elect out, otherwise its an Installment Sale

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## CONTINGENT PAYMENT INSTALLMENT SALE P 229

- If sale price cannot be determined by the end of the tax year
  - the taxpayer must use different rules to calculate the contract price and the gross profit percentage.
  - allocate the taxpayer's basis (including nonreal estate dealer selling expenses) to payments received and to be received

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## CONTINGENT PAYMENT INSTALLMENT SALE P 229-230

- State Maximum Sale Price
  - Treas. Reg. § 15a.453-1(c)(2)
  - a contingent payment sale is treated as having a stated maximum sale price if, under the terms of the agreement
  - the maximum amount of sale proceeds received can be determined as of the end of the tax year in which the sale or other disposition occurs.
  - The stated maximum sale price is determined by assuming
    - All Contingencies contemplated by the agreement are met
    - Resolved in a manner that will maximize the sale price
    - Accelerate payments to the earliest date or dates permitted under the agreement.

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## STATED MAXIMUM SALE PRICE
## P 229-230

- Taxpayer's basis is allocated to
  - payments received
  - to be received
- If the maximum sales price amount is later reduced
  - the gross profit ratio is recalculated for payments received in or after the tax year in which an event requiring reduction occurs.
- Treas. Reg. § 15a.453-1(c)(7)
  - A special rule applies if application of the rules would substantially and inappropriately accelerate or defer recovery of the taxpayer's basis

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## STATED MAXIMUM SALE PRICE
## P 230

- Example 7.1 – Determining the Initial Maximum Sale Price
- Fixed Period
- Treas. Reg. § 15a.453-1(c)(3)(i)
  - When a stated maximum sale price cannot be determined as of the close of the sale or other disposition tax year,
  - but the maximum period over which payments may be received under the con- tingent sale price agreement is fixed,
  - the taxpayer's basis (inclusive of selling expenses) is allocated to the tax years in which payment may be received under the agreement in equal annual increments.

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## TREAS. REG. § 15A.453-1(C)(3)(I) -- CONTINUED
## P 230

- If no payment is received or
- The amount of the payment received (exclusive of interest) is less than the basis allocated to that tax year
- No loss deduction is allowed
  - Unless the tax year is the final payment year under the agreement; or
  - Unless it is otherwise determined in accordance with the rules generally applicable to worthless debts that the future payment obligation under the agreement has become worthless.
  - The unrecovered portion of basis allocated to the tax year is carried forward to the next succeeding tax year.

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## COMPLETED SALES P 231

EXAMPLE 7.2 – NO MAXIMUM PRICE BUT FIXED TERM

**FIGURE 7.1**
**Installment Sale—Payments Exceed Basis**

| Year | Principal Payment | Basis Recovered | Gain on the Sale |
|---|---|---|---|
| 1 | $1,300,000 | $1,000,000 | $300,000 |
| 2 | $1,500,000 | $1,000,000 | $500,000 |
| 3 | $1,400,000 | $1,000,000 | $400,000 |
| 4 | $1,800,000 | $1,000,000 | $800,000 |
| 5 | $2,100,000 | $1,000,000 | $1,100,000 |

Treas. Reg. § 15a.453-1(c)(3)(ii), Example 1

EXAMPLE 7.3 – FIXED TERM PAYMENT IS LESS THAN ALLOCATED BASIS

**FIGURE 7.2**
**Installment Sale—Payment Less Than Basis**

| Year | Principal Payment | Basis Recovered | Gain on the Sale |
|---|---|---|---|
| 1 | $900,000 | $900,000 | $0 |
| 2 | $1,500,000 | $1,100,000 | $400,000 |
| 3 | $1,400,000 | $1,000,000 | $400,000 |
| 4 | $1,800,000 | $1,000,000 | $800,000 |
| 5 | $2,100,000 | $1,000,000 | $1,100,000 |

Treas. Reg. § 15a.453-1(c)(3)(ii), Example 2

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## NO STATED MAXIMUM SALE PRICE OR FIXED PERIOD P 232

**Treas. Reg. § 15a.453-1(c)(4)**

- If determined the sale has occurred
  - the taxpayer's basis (including selling expenses) is recovered in equal annual increments over a 15-year period commencing with the date of sale.
  - if in any tax year the taxpayer does not receive a payment or
  - the amount of payment received (exclusive of interest) is less than basis allocated to the year,
  - no loss is allowed unless the debt has become worthless.
  - Under the general rule, the excess basis is reallocated in level amounts over the balance of the 15-year term.
  - Any basis not recovered at the end of the fifteenth year is carried forward until all basis has been recovered or the future payment obligation is determined to be worthless.

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ISSUE 2

Business Bad-Debt Deduction

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BAD-DEBT
P 233

- Bona fide debt
- Unable to collect -- report a loss
- Business debt -- reduce ordinary income by reporting a bad-debt deduction.
- Non-Business debt -- may be allowed to report a short- term capital loss.
- Claim a bad-debt deduction in the year a business debt becomes partially or totally worthless.

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BAD-DEBT
P 233

I.R.C. § 166(d)(2) defines *business debts* by excluding the following debts

| Debts that were created or acquired in the taxpayer's trade or business | Debts that were related to the taxpayer's trade or business at the time they become worthless |
|---|---|

Treas. Reg.§ 1.166-5(b) -- Whether the debt is a business or nonbusiness debt is a question of fact in each case

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BAD-DEBT P 233

Created, Acquired or Related in Business

Treas. Reg.§ 1.166-5(b)(1) -- A debt created or acquired in the course of a trade or business is a business debt, regardless of the relationship of the debt to a taxpayer's trade or business at the time the debt becomes worthless.

Example 7.5 – Debt Created in Course of Business

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BAD-DEBT P 233

Treas. Reg. § 1.166-5(b)(2) – debt that is related to the taxpayer's business at the time it became worthless

I.R.C. § 165(c)(1) [Treas. Reg.§ 1.166-5(b)] – determination of debt is substantially the same as the determination of whether a loss was incurred in a trade or business for purposes of deducting business loss

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BAD-DEBT P 233-234

- Example 7.6 – Debt from a Former Business
- Example 7.7 – Debt Unrelated to Business
- Example 7.8 – Debt Acquired from a Decedent

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BAD-DEBT – TREAS. REG. 1.166-1(C) P 233-234

- *bona fide debt* -- debtor-creditor relationship
- valid & enforceable obligation to pay
- fixed or determinable sum of money.
- Accrual method -- claims the bad-debt deduction
- Cash method -- cannot take a business bad-debt deduction

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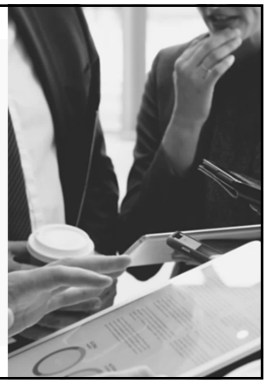
## TYPES OF BUSINESS BAD DEBTS P 234

- Loans to clients, suppliers, distributors, and employees;
- Credit sales to customers by an accrual basis taxpayer;
- Unpaid income of an accrual basis taxpayer; and business loan guarantees



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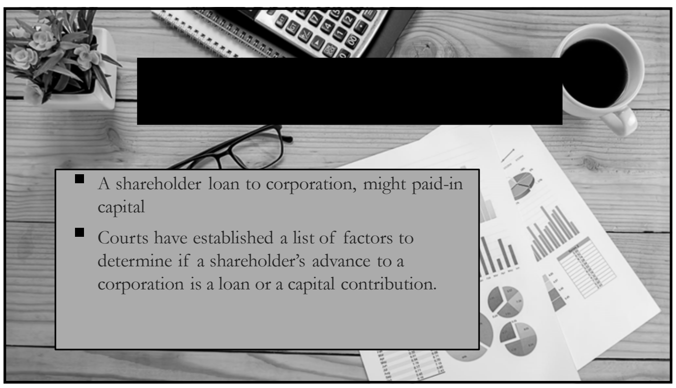

- A shareholder loan to corporation, might paid-in capital
- Courts have established a list of factors to determine if a shareholder's advance to a corporation is a loan or a capital contribution.

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## SHAREHOLDER LOANS P 234

1. The intent of the parties
2. The identity between creditors and shareholders
3. The extent of participation in management by the holder of the instrument
4. The ability of the corporation to obtain funds from outside sources
5. The "thinness" of the capital structure in relation to debt
6. The risk involved
7. The formal indicia of the arrangement
8. The relative position of the obligee as to other creditors regarding the payment of interest and principal

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## SHAREHOLDER LOANS – CONTINUED
## P 234-235

9. The voting power of the holder of the instrument
10. The provision of a fixed rate of interest
11. A contingency on the obligation to repay
12. The source of the interest payments
13. The presence or absence of a fixed maturity date
14. A provision for redemption by the corporation
15. A provision for redemption at the option of the debt holder
16. Timing of the advance with reference to the organization of the corporation

[*Fin Hay Realty Co. v. United States*, 398 F.2d 694 (3d Cir. 1968); see also *Dixie Dairies v. Commissioner*, 74 T.C. 476 (1980)]

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P 234-235

## Example 7.9 – Loan to a Supplier

### Credit Sales

| Business bad debts may arise from credit sales to customers. | Uncollectible receivable becomes a business bad debt. | Accrual Method | Cash basis taxpayers generally cannot claim a bad-debt deduction |
|---|---|---|---|

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## TYPES OF BUSINESS BAD DEBTS P 235

- Unpaid Income - wages, salaries, fees, rents, and similar items of taxable income are not deductible under §166
- Example 7.10 – Cash Basis Service Provider
- Example 7.11 – Accrual Method Service Provider

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## BUSINESS LOAN GUARANTEES P 236

Treas. Reg. §1.166-9 – if the taxpayer guarantees a debt that defaults, can qualify as a business bad debt if all the following requirements are met:

- Guarantee made in the course of his or her trade or business
- The taxpayer has an enforceable legal duty to pay the debt.
- Guarantee made before the debt became worthless.
- The taxpayer received reasonable consideration for making the guarantee.

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## BUSINESS LOAN GUARANTEES P 236

- *Reasonable consideration* is not limited to direct consideration in the form of cash or property.
- Normal business practice or for a good-faith business purpose, the payment is a business bad debt.
- Consideration received from a taxpayer's spouse or from a taxpayer's qualifying child or qualifying relative for purposes of the I.R.C. § 152(a) definition of a dependent must be direct consideration in the form of cash or property.
- Example 7.12 – Business Loan Guarantee

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## TOTALLY WORTHLESS BUSINESS DEBT P 236

- Taxpayer claims the business bad-debt deduction in the year that the debt becomes partially or completely worthless.
- A debt becomes worthless when there is no longer any chance the amount owed will be paid.
- Taxpayer must demonstrate he or she took reasonable steps to collect the debt but was unable to do so.

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## TOTALLY WORTHLESS BUSINESS DEBT P 236

- Treas. Reg. § 1.166-2(a) - whether a debt is partially or totally worthless
  - the financial condition of the debtor and the value of any collateral that secures the debt
- Court judgement debt is uncollectible -- does not have to sue the debtor to show the debt is worthless.
- Bankruptcy of the debtor is generally good evidence of the worthlessness of at least a part of an unsecured and unpreferred debt.

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## TYPES OF BUSINESS BAD DEBTS P 236-237

- Practitioner Note – Jointly Held Debt
- Guaranteed loan is a bad debt in the year of the payment unless the taxpayer has the right to demand payment from the borrower.
- The taxpayer cannot claim a bad-debt deduction until the right to demand payment from the borrower becomes worthless.

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## CLAIMING BAD-DEBT DEDUCITON P 237

- Specific charge-off method
  - the taxpayer claims the deduction in the year the debt becomes partly or totally worthless.
- Partly Worthless Debt -- taxpayers cannot deduct a partly worthless business debt until they charge it off in their accounting records.
  - Charge it off and claim the deduction in the year it becomes partly worthless.
  - Charge it off and deduct it in a later year, but not after the year it becomes totally worthless
- Totally Worthless Debt -- can deduct the entire amount less any amount deducted in an earlier tax year when the debt was only partly worthless.

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## TYPES OF BUSINESS BAD DEBTS P 237

- Claim for a Refund
  - If the bad debt was totally worthless, the taxpayer must file the claim by the *later* of the following dates:
    - 7 years from the date the original return was due (not including extensions)
    - 2 years from the date the taxpayer paid the tax
    - If the claim is for a partly worthless bad debt, the taxpayer must file the claim for credit or refund by the *later* of the following dates:
    - 3 years from the date the taxpayer filed the original return
    - 2 years from the date the taxpayer paid the tax
- Practitioner Note – Physical or Mental Impairment

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## REPORTING BUSINESS BAD DEBT DEDUCTION P 237

- Taxpayers report business bad debts on the form or schedule where they report other business deductions
  - Schedule C (Form 1040), Profit or Loss From Business;
  - Schedule F (Form 1040), Profit or Loss From Farming;
  - Form 1065,U.S. Return of Partnership Income;
  - Form 1120- S, U.S. Income Tax Return for an S Corporation; or
  - Form 1120, U.S. Corporation Income Tax Return.
  - Employees report business bad debts as a miscellaneous itemized deduction subject to the 2%-of-AGI floor (when such deductions are allowed).

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## REPORTING BUSINESS BAD DEBT DEDUCTION P 237-238

- Reporting Business Bad-Debt Deduction – continued
- Example 7.13

**FIGURE 7.3**
**Part V of Sam Miller's 2024 Schedule C (Form 1040)**

**Part V** **Other Expenses.** List below business expenses not included on lines 8–26, line 27b, or line 30.

| | |
|---|---|
| Business bad debt for loan to Summit Cycles, Inc. on December 18, 2023. The $75,000 remaining loan balance became totally worthless on September 5, 2024 when the bank repossessed all Summit Cycle's assets and it went out of business. | 75,000 |
| 48 **Total other expenses.** Enter here and on line 27a . . . . . 48 | |

Schedule C (Form 1040) 2023

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