



## Real Estate Loans Gone Bad

*A long-time real estate investor who also made occasional loans has learned the hard way about what does — and doesn't — qualify as deductible business bad debt.*

*By Joel Glucoft, CPA, Partner | NSBN LLP*

The U.S. Tax Court, in *Langert v. Commissioner*, ruled that a real estate investor could not deduct about \$153,000 in outstanding debt, and the Court clearly explained the requirements that must be satisfied before a taxpayer can claim a bad debt deduction.

### A Handshake Is Not Sufficient

The taxpayer had been involved for about 30 years in real estate activities, including buying, selling and renting real property and providing management services. During that period, he made six loans, but he never advertised himself as a moneylender, or kept a separate office, or separate books and records relating to any of the loans.

In 2003, he transferred about \$157,000 to an individual to help finance the purchase of some property. The individual and his mother signed a document titled "Unsecured Note." They weren't required to provide collateral. The taxpayer never checked his credit ratings and didn't require any financial statements or other pertinent financial information. He also failed to verify the source of funds that would allow him to comply with the terms of the note.

After making 28 monthly payments, the debtor defaulted on the loan. The taxpayer/lender asked him orally, not in writing, to pay the outstanding debt. He didn't ask the debtor's mother to pay the debt, nor did he pursue any legal remedy for the default. When the debtor filed for bankruptcy, the taxpayer didn't file a claim for the debt with the court. He also didn't contact the foreclosure trustee or file a claim when the property went into foreclosure auction.

The taxpayer claimed a deduction for his loss on Schedule C ("Profit or Loss from Business") of his 2009 tax return. The IRS subsequently issued the taxpayer a notice of deficiency that disallowed the deduction.

### Court Nixes Deduction

In Tax Court, the taxpayer claimed he was entitled to a deduction for a "business bad debt" because he had made the loan for the sole purpose of obtaining interest income. As the court noted, for all or a portion of a debt to be deductible as a bad debt, the debt must, among other things, constitute 1) a debt created or acquired in connection with a trade or business or 2) a debt from which the loss is incurred in the taxpayer's trade or business.

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The mere fact that a taxpayer makes a loan solely to obtain interest income, the Court said, doesn't on its own lead to a finding that the loan is deductible. Moreover, for a taxpayer to be entitled to a bad debt deduction in connection with the trade or business of lending money, the debt must have been sustained in the course of loan-making activity that was "so extensive and continuous as to elevate that activity to the status of a separate business."

The Court found that making six loans over 30 years, during which the taxpayer conducted real property activities, didn't elevate the loan activity to the status of a separate business. In support, it cited a previous case where the Court found that making eight or nine loans over four years didn't elevate the activity to separate business status.

### **The Tax Implications**

The lack of full due diligence in making a loan and little formal collection effort is something that happens often when making loans to friends and family. In such cases, the IRS may not allow any deduction.

If the loan is truly worthless the taxpayer might be able to treat the bad debt as a *capital loss*, subject to the strict annual limit of \$3,000.

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