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Family matters

Are cash advances gifts or loans for tax purposes?

When friends and family members are struggling to make ends meet, loved ones may give or lend money to help. This situation has become common during the COVID-19 crisis, but it's important for clients to understand the rules regarding how transfers are classified for tax purposes.

Gifts are typically made without strings attached. Loans are made with the *expectation* of repayment and *intent* to enforce the debt — but those conditions may change over time. A recent U.S. Tax Court decision highlights the tax implications of such changes.

Case in point

The decedent in the *Estate of Bolles* was the mother of five. She wanted each of her offspring to receive an equal amount of the assets in her estate. So, she kept a detailed record of each child's advances and repayments, treating the advances as loans. She forgave the "debt" account of each child every year based on the annual gift tax exemption amount.

> Though the decedent recorded the advances to her son and tracked interest on them, the court found no written loan agreements or attempts to force repayment.

One of her sons took over his father's architectural firm but ran into financial difficulties, "largely because his expectations exceeded realistic results." He eventually needed help from a trust that his mother and father had formed when they divorced. Despite already owing almost $160,000 to the trust, the son was given permission to use $600,000 in trust property as collateral to secure $600,000 in bank loans. After the son defaulted, the trust ended up on the hook for the loans. Nonetheless, from 1985 to 2007, the decedent transferred roughly $1.1 million to, or for the benefit of, the son.

In October 1989, the decedent created a revocable trust, which specifically excluded the son from distributions at her death. She later amended the exclusion, providing a formula to account for the loans she made to him. At that time, the son signed an acknowledgement that he lacked the capacity to repay any loans and agreeing that the loans, with interest, would be taken into account for purposes of trust distributions.

After the mother died, the IRS contended that transfers to the son from 1985 to 2007 were "adjusted taxable gifts" that should be included in

Gift transfer document determines value, not donor's intent

In *Nelson v. Commissioner*, the U.S. Tax Court dealt a blow to a taxpayer who attempted to use transfer clauses when valuing interests in a family limited partnership (FLP). Although the court found the clauses controlling, it interpreted them in a way that apparently conflicted with the taxpayer's intent.

The taxpayer made two transfers of FLP interests. According to transfer documents, the interests had fair market values (FMVs) of approximately $2.1 million and $20 million, respectively, as determined by a qualified appraiser within a fixed period after the transfers. An appraiser subsequently determined that the transfers were of 6.14% and 58.65% FLP interests, respectively.

The issue for the court was whether the transfers were of fixed dollar amounts, as the taxpayer contended, or percentage interests, as the IRS asserted. The court found that the taxpayer essentially wanted to interpret the transfer clauses by ignoring the "qualified appraiser within [a fixed period]" phrase and replacing it with "for federal gift and estate tax purposes."

The taxpayer may have intended this but, as the court held, that's not what the transfer clauses said. Because the transfer documents required an appraiser to determine the interests being transferred, the taxpayer transferred percentage interests, not dollar amounts.

The court went on to find that the percentage interests had FMVs of about $2.5 million and $24 million, respectively. As a result, the taxpayer had undervalued the transfers for tax purposes.

her gross estate. The estate claimed the transfers were worthless loans.

Split verdict

The Tax Court explained that, when it comes to intrafamily transfers, an actual *expectation* of repayment and *intent* to enforce the debt are critical if a transaction is to qualify as a loan for tax purposes. Although the decedent recorded the advances to her son and tracked interest on them, the court found no written loan agreements or attempts to force repayment.

The court noted that the reasonable possibility of repayment was an objective measure of the decedent's intent. But it dismissed the estate's argument that the decedent always considered the advances to be loans. The court couldn't reconcile the argument with the deterioration of the son's financial situation and the two failures of his practice.

The court conceded that the decedent was slow to lose her expectation that her son would make a success of the practice as his father had. But it determined that she realized he was "very unlikely" to repay the loans by October 1989, when her trust specifically blocked his receipt of assets at her death. As a result, the court concluded that the advances to her son were loans through 1989, but thereafter they were gifts.

Tread carefully

Despite her good intentions, the decedent's failure to follow formal note agreements when making loans backfired. Each transaction must be handled in a specific manner to achieve the desired treatments. The facts and circumstances on the date of transfer are critical when determining whether advances will be treated as loans or gifts for tax purposes — and circumstances may change over time. ■

Spotlight on fraud in the nonprofit sector

Times of crisis bring out the best — and worst — in people. Some individuals respond by reaching into their pocketbooks to help those in need. On the flip side, fraudsters may try to profit from that generosity. For example, dishonest workers might try to siphon funds from legitimate charitable organizations, or a perpetrator might set up bogus organizations that misappropriate donations for personal gain.

During the COVID-19 pandemic, it's critical for not-for-profit organizations to remain diligent in their efforts to combat fraud. But to prevent illicit financial activities, your nonprofit clients must strike a balance between a culture that values trust with the need for strong internal controls.

Implement strong controls

A general lack of financial and staff resources — in addition to less vigorous oversight and enforcement of internal controls — can make not-for-profits vulnerable to fraud. Executives and managers may, for example, override internal controls, allow unproven staffers to accept cash donations, rubber-stamp expense reimbursement reports or neglect to segregate accounting duties.

To mitigate this threat, management should evaluate the organization through the eyes of a fraudster. If you intended to steal, where would you focus your efforts? If security gaps are uncovered, the client should devise a control that will close them.

For example, many organizations still receive some donations in the mail. If one person is responsible for opening envelopes, recording contribution amounts, and depositing cash or checks, it would be easy for that person to commit fraud. So, management needs to devise mechanisms that could prevent a staffer or volunteer from skimming donations. A common anti-fraud control stipulates that two or more people be involved in the process of collecting, recording and depositing checks. This is known as segregation of duties. Nonprofits also should perform background checks on anyone who'll be handling money.

Stress test safeguards

Unfortunately, the existence of controls doesn't guarantee they're being followed. While internal controls provide a deterrent from wrongdoing, they can sometimes be circumvented by fraudsters. Nonprofits, by their nature, are geared toward "doing good," not making money. So, staffers may not be attentive to financial irregularities. And in non-hierarchical or "flat" organizations, managers may not prioritize enforcing controls, which means staffers who want to bypass them usually can.

Regular control compliance checks can help ensure that internal control procedures are being followed. The key is to find out which rules are

routinely ignored — and why. Say, for instance, that the employee handbook calls for two levels of approval for expense reimbursement requests. If staffing shortages are causing employees to sidestep this rule, consider asking board members to step in when a second signature is required to make a large disbursement. Another possible solution is to use an outside accounting firm for certain booking tasks, including expense report approvals. In general, independent external accountants tend to be more likely to refuse to process requests that lack proper authorization.

> Regular control compliance checks can help ensure that internal control procedures are being followed.

Educate employees and volunteers

Another effective anti-fraud control is training. During orientation, employees and volunteers should be taught about common fraud ploys in the not-for-profit sector, along with methods of prevention and detection. They should learn how to report any suspicious activity they encounter while working at the organization. Nonprofits should follow up with annual "refresher" courses for existing employees, because fraudsters are always finding new ways to steal or hide their wrongdoing.

Approximately 40% of nonprofit frauds are revealed by tips from staffers, board members, vendors, clients and the public, according to *Report to the Nations: 2020 Global Study on Occupational Fraud and Abuse.* The Association of Certified Fraud Examiners' report recommends offering an anonymous fraud-reporting mechanism that whistleblowers can use via phone, online and email.

Seek outside expertise

The ultimate goal of an internal controls system is to protect an organization and its assets from thieves. If nothing else, fraud prevents nonprofits from fulfilling their missions. For more information about not-for-profit fraud schemes, contact a forensic accounting professional. He or she can help create awareness within a client's organization, as well as help strengthen internal controls and investigate suspected wrongdoing. ■

Owners' compensation: Determining what's reasonable

At year end, it's common for business owners to reflect on the year's performance and decide whether they've been fairly compensated for their efforts. If the business has extra cash on hand, owners may decide to pay themselves a holiday bonus or make a special distribution to help cover their personal tax obligations from earnings from a pass-through business. Here are some important issues for your clients to consider before they cut a check.

Why compensation matters

When owners take cash out of a business, it may affect business value, because there's less cash available to fund growth opportunities and pay off debt. That's why owners' compensation is often an issue during divorce settlements and shareholder disputes. In these situations, courts may award amounts to noncontrolling stakeholders — namely, former spouses and dissenting shareholders — based on

the value of the business. Likewise, compensation levels may affect child support and alimony payments.

In such cases, it may be appropriate to adjust an owner's compensation. Adjusted compensation levels reflect the amount the owner could expect to receive for performing comparable duties at an unrelated business entity. When making an adjustment, it's critical to consider all types of compensation, including W-2 wages and bonuses, benefits, profit sharing, stock options and other perks. Dividends (or distributions) and low-interest loans the business gives to owners and other related parties could represent other forms of compensation.

The IRS also may question whether business deductions for owners' compensation are reasonable for tax purposes. For C corporations, the primary issue is whether the company is *overpaying* deductible W-2 compensation to owners to avoid double taxation on nondeductible dividends.

For pass-through entities, such as S corporations, the IRS looks for the reverse: companies that are *underpaying* owners to avoid payroll taxes on W-2 compensation and instead classifying payments to shareholders as nontaxable distributions.

How much is reasonable?

Salary levels can vary significantly based on an individual's duties, training and experience. The company's performance, geographic location and industry can also affect pay levels.

The IRS guide *Reasonable Compensation: Job Aid for IRS Valuation Professionals* provides insight into how to determine reasonable compensation levels. Relevant considerations include:

- External salary surveys, such as Willis Towers Watson's executive salary surveys, the Risk Management Association's Annual Statement Studies® and Economic Research Institute's quarterly salary surveys,
- Compensation data from comparable companies — for example, the ratio of overall owners' compensation compared to comparable company sales,
- A taxable income comparison, such as how the compensation affects the company's taxable income, and
- Ratios of owners' compensation to median employee compensation.

The guide emphasizes how objective market data can be used to estimate reasonable compensation. In addition to the sources listed, also consider studies published in trade journals and interviews with headhunters who specialize in the client's industry.

Salary levels can vary significantly based on an individual's duties, training and experience.

Supporting compensation levels

Business valuation professionals can provide objective insight on owners' compensation levels by researching comparable market data. Then they can use that data to estimate how much an owner-employee would receive for performing similar services, based on the characteristics of the company, market and individual, and adjust the company's financial statements accordingly. ■

County of Maricopa v. Office Depot Inc.

Is that expert report final — or a draft?

The question of whether an expert's report is a draft, and therefore not subject to discovery, is a hot topic in some federal and state courts. A recent federal district court case involving a contract dispute demonstrates the stakes involved when making this determination.

Discovery disagreement

The plaintiff alleged a breach of a pricing commitment. The defendant argued that one of the plaintiff's experts should be precluded from testifying because the plaintiff violated Rule 37 of the Federal Rules of Civil Procedures (FRCP) by failing to disclose his *full* expert report.

The expert testified in deposition that he had included an additional column in a spreadsheet attachment when he submitted his report to the plaintiff. A column, titled "Notes," listed his thinking and questions regarding the items he was categorizing. That column wasn't included in the final version produced to the defendant, however.

The plaintiff argued that the spreadsheet was part of a *draft* report and, therefore, was exempt from disclosure under FRCP Rule 26. Moreover, the plaintiff claimed, the final report fully stated the expert's conclusions and opinions.

Court analysis

As the U.S. District Court for the District of Arizona noted, Rule 26 requires an expert report to include "a complete statement of all opinions the witness will express and the basis and reasons for them." If a party violates this disclosure requirement, the expert can't testify at trial unless the failure was substantially justified or harmless. But a party isn't required to disclose *draft* reports.

The court pointed out that case law provides little guidance when it comes to determining whether a report was a draft or final version. Courts generally look at such factors as whether a document was created to be included in the final report and whether it was included in earlier versions of the report.

The court ultimately found, consistent with "experience and common sense," that the report with the Notes column was a *draft*. It concluded that final versions of expert reports usually don't contain the expert's "incompletely-expressed musings and notations." Most important, the defendant didn't challenge the reasoning and explanation provided in the report, other than to argue it also should have received the version with the Notes column. This bolstered the conclusion that the analysis in the version provided to the defendant constituted a complete expression of the expert's opinions.

Know the rules

Many states' rules adhere closely to the FRCP, but not all. It's important to fully understand the relevant rules of evidence to minimize the risk of forfeiting an expert's testimony in court. ■

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