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How Can I Claim a Business Bad Debt Deduction?

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The Internal Revenue Code permits a business bad debt deduction when a customer fails to pay for the services rendered or the products supplied by your business. However, the ability to claim an ordinary deduction with respect to the worthless debt depends on a variety of factors, and you should be ready to substantiate your position if the IRS ever challenges it.

Key Issues

- **Deduction.** Whenever you offer services or sell a product to a customer on credit, there is always the possibility that the customer will not pay. However, under Section 166(a) of the Internal Revenue Code, you may be eligible to claim an ordinary deduction in the taxable year when a debt becomes completely or partially worthless, but only to the extent of the worthlessness.

- **Debtor/Creditor Relationship.** To claim an ordinary deduction, a debtor-creditor relationship must exist. In other words, the debtor must be legally obligated to pay you a fixed or determinable sum of money.

- **Type of Debt.** The ability to claim an ordinary deduction only applies to *business* bad debts where the debt is not treated as a security for federal income tax purposes. A debt instrument will be treated as a *security* for these purposes if the instrument is issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form. If a debt treated as a security becomes worthless, the related loss would be deductible as a capital loss, not an ordinary deduction. Additionally, for non-corporate lenders, if the debt is a *nonbusiness* bad debt, then the loss would only be deductible as a short-term capital loss and is only deductible if the debt is wholly worthless (not merely partially worthless). A nonbusiness bad debt generally would be a debt other than one created in your trade or business.

- **Basis.** The amount used to determine your bad debt deduction is your adjusted tax basis in the debt, not the debt's face value. If you were the original lender with respect to a debt issued for cash, your tax basis in the debt generally would be the amount of cash loaned. If the debt was purchased from another person, the adjusted tax basis of the debt would be the purchase price. For accounts receivable, the adjusted basis generally is the amount included in gross income on the sale or provision of services that gave rise to the account receivable. Thus, the method of tax accounting used by the holder of the accounts receivable will be important in determining the tax basis for accounts receivable, as the adjusted basis of accounts receivable of a cash method taxpayer is generally zero before receipt, but an accrual method taxpayer would be expected to have included some amount in income with respect to the account receivable, providing some tax basis in the account receivable.

- **Included in Income.** If the debt arose from unpaid wages, salaries, fees, or similar items of taxable income, then you are not eligible for a bad debt deduction unless you have included those amounts in your taxable income. For example, if you operate on the cash basis method of accounting and provide services for a fee, you would only include the amounts actually received in your income. If you never received a payment, you would never include the fee in your taxable income and therefore are not allowed a deduction when you write-off the debt owed you.

- **Timing.** The deduction for the business bad debt must be taken in the year the debt becomes worthless, or the year it becomes partially worthless. In other words, the debt must have value at the beginning of the year and then become worthless, or partially worthless, during the year in which the deduction is taken. It is the creditor's responsibility to prove worthlessness, but that can be challenging to prove and is determined based on all relevant facts and circumstances. Tax regulations note that a bad debt deduction is available if "the surrounding circumstances indicate that a debt is worthless and uncollectible and that legal action to enforce payment would in all probability not result in the satisfaction of execution on a judgment." For an unsecured and somewhat subordinated debt, borrower bankruptcy or insolvency would generally be a solid indicator of at least partial worthlessness. Even if the debt meets all the other criteria for deduction, the IRS could always take the position that the debt became worthless in a previous year. This would result in an understatement of income in the year the deduction is claimed, because the IRS denied the deduction, and an overstatement of income in the previous year where the IRS claimed the debt actually became worthless. If the statute of limitations closed on that previous year, then you would be prohibited from amending your tax return and claiming that deduction. With respect to the statute of limitations for refund claims based on worthless debts, the Internal Revenue Code extends the statute of limitations from the typical three years to seven years.

- **Recovery of Bad Debts.** To the extent you recover a debt you previously claimed as worthless and took a bad debt deduction against, you would have to include such recovery amount in your gross income, but only to the extent that a previous deduction created a tax benefit for you.

Takeaway

When a debt becomes uncollectible, it is important to understand the requirements that must be met for you to claim an ordinary deduction with respect to the write-off of that debt. It is important to evaluate the worthlessness of debt on a continuous basis when there is a risk of nonpayment, and documenting the facts that are expected to trigger full or partial worthlessness is important in the event of an IRS challenge.