

Can You Write Off A Bad Debt?

By Charles Clar

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This feature deals with USA tax laws and how you can use them to your advantage. It is made available on a more or less weekly basis.

Can You Write Off A Bad Debt?

Can bad debts can be deducted in tax returns? Many times the answer is yes.

You do need to understand the difference between business and nonbusiness bad debts.

A business bad debt is generally one that comes from operating a trade or business. It is deductible only if the amount owed has already been included in business income.

For example, if you billed Company ABC \$1,000 and they stiff you for it, you can only deduct the \$1,000 if you have already included that amount in business revenue. This implies that your company has adopted the accrual form of accounting (report it when you earn it rather than when you receive it). Most small business owners do not do this, nor should they.

You can, however, deduct all the actual costs of earning the income, like travel, employee salaries, office supplies, etc. But you could do this anyway. If someone won't pay, your practical options include negotiating a reduced payoff or going to court. But you typically receive no tax deduction for the lost income.

All other bad debts are nonbusiness. The most common example by far is a personal loan you make to someone. Nonbusiness bad debts must be totally worthless to be deductible. You cannot deduct a partially worthless nonbusiness bad debt. You must be able to prove that you have taken reasonable steps to collect the debt, like going to court and sending demand letters.

You may take the deduction only in the year the debt becomes worthless; you do not have to wait until the debt comes due. A debt becomes worthless when there is no longer any chance the

amount owed will be paid. Your debtor declaring bankruptcy is an obvious way to prove a loan is worthless. You also must be able to prove you actually made the loan, like with a cancelled check and a signed promissory note.

Deducting a non-business bad debt requires that you attach a separate detailed statement to your return. You report the amount on Schedule D as a short term capital loss. This means its current year deductibility depends upon the rules governing capital gains and capital losses. More on this next week.

If the person who owes you the money is a family member, then be extra certain to document everything. A 'loan' to Mary or John, who just happens to be your daughter or son, is almost never deductible.

As always, PLEASE make sure you read and understand the fine print. It wouldn't be taxes in America otherwise!

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<http://all-about-taxes.com>

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