

Bad Debt Deduction

If someone owes you money that you cannot collect, you may have a bad debt. To deduct a bad debt, you must have previously included the amount in your income or loaned out your cash. If you are a cash basis taxpayer, as most individuals are, you may not take a bad debt deduction for income you expected to receive but did not because the amount was never included in your income. For a bad debt, you must show that there was an intention at the time of the transaction to make a loan and not a gift.

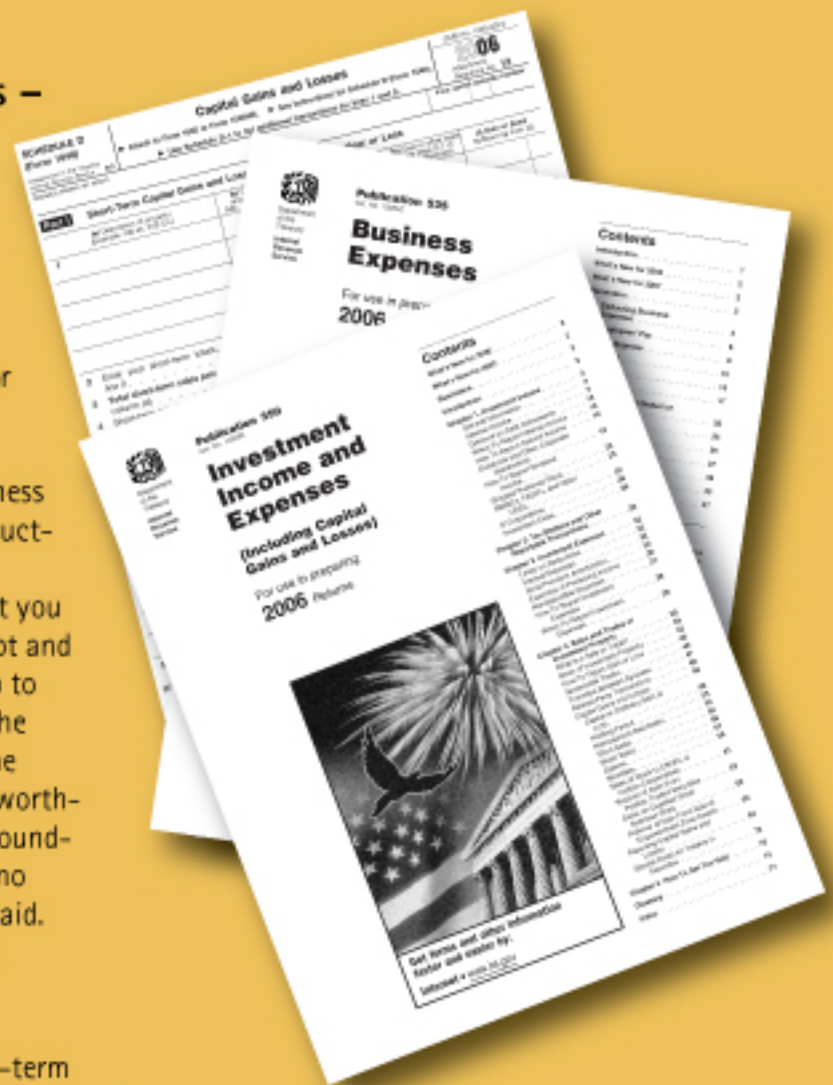
There are two kinds of bad debts – business and nonbusiness.

A business bad debt, generally, is one that comes from operating your trade or business. A business deducts its bad debts from gross income when figuring its taxable income. Business bad debts may be deducted in part or in full.

All other bad debts are nonbusiness. Nonbusiness bad debts must be totally worthless to be deductible. You cannot deduct a partially worthless nonbusiness bad debt. You must establish that you have taken reasonable steps to collect the debt and the debt is worthless. It is not necessary to go to court if you can show that a judgment from the court would be uncollectible. You may take the deduction only in the year the debt becomes worthless. A debt becomes worthless when the surrounding facts and circumstances indicate there is no longer any chance the amount owed will be paid. You do not have to wait until a debt is due to determine whether it is worthless.

A nonbusiness bad debt is reported as a short-term capital loss on Form 1040, Schedule D. It would be subject to the capital loss limitations. A nonbusiness bad debt deduction requires a separate detailed statement attached to your return.

For more information on nonbusiness bad debts, refer to IRS' Publication 550, Investment Income and Expenses and for more information on business bad debts, refer to Publication 535, Business Expenses.



For more info, please contact:

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