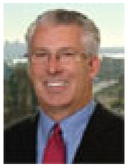

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## Bad Debt Deductions in a World of Uncertainty

Tips revealed on making the most out of bad loans, advances or receivables.

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In today's faltering credit markets, it has never been more important to understand the specifics behind the tax rules for claiming deductions for bad debts. For many businesses, trade and other receivables represent some of the largest assets on the balance sheet. As we approach year-end and enter a period of potential economic downturn, the possibility increases that taxpayers won't be fully paid for trade receivables and other debt instruments.

In order to mitigate the financial impact of debts gone sour, it is important to understand the tax provisions applicable to partially worthless, wholly worthless, secured and non-business bad debts. What is considered a bad debt to the taxpayer may not necessarily represent a bad debt in the eyes of the tax authorities. In addition, taxpayers' bookkeeping practices with respect to tracking receivables is also critical in determining the amount and timing of bad debt deductions.

Discussed below are a few tips for making the most out of a bad loan, advance or receivable.

### Cash Basis vs. Accrual Basis

The first factor to consider before claiming any bad debt expense is whether the taxpayer reports on the cash or accrual basis. A cash basis taxpayer generally has no basis in its trade receivables (unless they purchased the receivable), and, therefore, no tax deduction is allowed. This often comes as a surprise to certain taxpayers, but once they understand that they have never reported the receivable in taxable income, they tend to grasp the concept.

The Tax Reform Act of 1986 repealed the reserve method for claiming bad debt deductions for most accrual basis taxpayers other than small banks and thrifts. Therefore, accrual basis taxpayers can generally only claim bad debts to the extent they charge off all or a portion of specific receivables.

### Partial and Complete Worthlessness

Generally, an "ordinary" bad debt deduction is allowed for all or a portion of bona fide debt (other than a nonbusiness bad debt and a debt evidenced by a security) that becomes worthless during the tax year. Non-business bad debts are generally only deductible in the year it becomes wholly worthless and are treated as short-term capital losses under Reg. § 166-5(a)(2).

Under IRC §166(a)(2), the deduction for specific bad debts that become partially uncollectible is limited to the amount of actual “charge-off” or write-down of specific receivables during the tax year. The term “charge-off” can be broadly interpreted. The principal reason for the requirement is to prevent a taxpayer from taking advantage of the loss for tax purposes while continuing to carry the item on its financial statements as an asset for financial statement purposes. As seen in *Com. v. MacDonald Engineering Co.*, (1939, CA7) 22 AFTR 975, 102 F2d 942, 39-1 USTC, the mere intent to eliminate an item from the books was considered adequate to take a tax write-off. The crediting of accounts receivable with the amount of the worthless portion of the debt is also a sufficient charge-off as demonstrated in *Houghton & Dutton Co.*, (1932) 26 BTA 52. The taxpayer does not have to annually charge off and deduct the partially worthless debt. Instead the taxpayer may delay the charge-off, and resulting tax deduction, until a later year, which could make sense for a taxpayer in a Net Operating Loss position.

However, it is generally recommended that taxpayers charge off the estimated uncollectible portion of all receivables and loans in the year it is reasonably measurable. If a taxpayer procrastinates, the taxpayer may lose all or a portion of their deduction, since taxpayers are precluded from deducting any part of a debt after the tax year in which it becomes wholly worthless.

Wholly worthless bad debts require very strict requirements before a full deduction can be claimed. Reg. §1.166-2 does not specifically define worthlessness but merely speaks of ‘‘evidence of worthlessness.’’ The regulations further provide that where 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, the facts are sufficient to establish the worthlessness of a debt under §166.

Because a taxpayer must show that the debt had value at the beginning of the taxable year and no value, or reduced value in the case of a partial write-off, at the end of the taxable year, it is essential to point to certain factors or events which took place during the taxable year that support the conclusion of worthlessness in the given year. An indication of financial difficulties, alone, does not establish worthlessness. Even bankruptcy does not always indicate worthlessness, although in certain situations can be reason to support worthlessness.

Similar to worthless security deductions, if the tax authorities can show that even some nominal collections are possible, or third-party value is present, the taxpayer will have a difficult time claiming a wholly worthless bad debt — but should certainly attempt to document the partially worthless amount(s) in the earliest year possible.

Although not determinative for all cases, courts have accepted several conditions as circumstances indicating worthlessness. Some noteworthy events include the following:

1. The debtor's disappearance or departure from the country;
2. The debtor's death;
3. A decline in the debtor's business;
4. The worthlessness of a judgment against the debtor;
5. The withdrawal of financing on a real estate venture;
6. The decline in value of the property secured during the debt; and
7. The uncollectibility of a deficiency on the sale of mortgaged property.

***Example:*** Abel is a one-third owner and president of **B Corp**. Abel loans **B** $250,000. In 2007, **B** defaults on its only contract, having received only $175,000 of the total contract price of $500,000. In late 2007, Abel arranges for a $275,000 loan to **B** from a third-party. At the end of 2007, **B** has assets of $190,000 and liabilities of $850,000 and its prospects are slim given the loss of the contract. Despite its financial problems, **B** continues its operations throughout 2007. Abel is not entitled to a wholly worthless bad debt deduction in 2007 for its loans to **B**. Despite **B**'s balance sheet insolvency and business reversal, it continued as a going concern. Moreover, **B**'s ability to obtain the third party loan indicates that **B**'s financial condition is not hopeless. Abel may be able to claim a partially worthless bad debt for the 2007 tax year to the extent he can make a reasonable estimate of the projected uncollectible amount and charges such amount off for that tax year.

The taxpayer should thoroughly document the collection efforts and clearly memorialize the point in time that all or a portion of the debt deteriorated in value, or becomes wholly worthless. To the extent the taxpayer ends up recovering receivables which had been written off in prior years, such recoveries are generally reportable in the subsequent year under Regs. § 1.661-1(f).

**Documentation of Loans**

Very often, equity owners enter into loan agreements with their affiliated business entities, both in a lending and borrowing role. However, due to the nature of these related-party transactions, tax authority scrutiny, lack of taxpayer documentation and improper execution, often creates problematic loan agreements.

In order to have a bona fide loan arrangement, the following conditions are generally recommended for all loans:

1. The loan should be documented in a written agreement,
2. The loan must be interest-bearing at a prescribed rate that is within the published IRS guidelines (e.g. § 7872),
3. The provisions must include specific payment terms of interest and principal, and
4. Actual payments of interest must be made consistent with the terms detailed in the loan agreement.

If a related-party loan is set up improperly, the IRS may:

- Recast a loan made to a business as a capital contribution, disallowing all interest deductions, and causing unintended tax results upon repayment.
- Impute interest income (to lender) and interest expense, (to borrower).
- Deem a loan received by an equity holder as wages, taxable dividend or other taxable distribution, subject to all applicable withholdings and reporting requirements.

This re-characterization can cause even more issues for transactions involving cross-border (state or international) borrowings.

The IRS’s re-characterization may also entail some form of penalty (e.g., late payment, etc. for non-withholding and untimely reporting in a deemed wage payment scenario). Therefore, it is important to take the necessary steps when the loan is made to avoid these potential complications down the road.

Additional issues, which need to be considered include: potential advantages of “term loans” over “demand loans” (particularly with the current low interest rates), estate/income tax advantages of intra-family loans, timing of income/expense between cash and accrual basis taxpayers and special rules applicable to loans between U.S. and foreign companies.

In conclusion, with proper documentation procedures in place, a taxpayer can maximize current year deductions for bad debts through partial write-offs as well as securing the write-off of an entirely worthless investment on their books when applicable. The charge-off method, when applied correctly, can accelerate a deduction on the books that would otherwise be missed.

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