

### *Idea of the Month*

## **Business and Nonbusiness Bad Debts**

Most of us will incur financial losses in our business and personal lives at some point, and an economic environment like the one we are in certainly increases the odds. A common type of loss is a bad debt. We'd like to discuss business and nonbusiness bad debt and give you tips on deriving the maximum tax benefits from them.

Whether a loan is made in the course of business or to a friend or relative, sometimes it simply cannot be repaid despite the best intentions of the debtor. If there is little or no prospect that repayment can be made in the future, you may have a bad debt.

The first step is to determine whether a real debt exists. There must be a valid and legally enforceable obligation to pay you a fixed or "determinable" sum of money. Loans between family members – or between other related parties such as corporations and their shareholders – are scrutinized particularly closely by the IRS to make sure that they are really debts rather than disguised gifts, dividends, or contributions to the corporation's capital.

If you are contemplating making a loan to a related party, you must ensure that you treat the transaction as a true loan by taking the steps that an arm's-length lender would take, such as putting it in writing and charging a reasonable rate of interest. This reasonable rate of interest, as defined by the IRS, is currently at historic lows.

You must then determine if, and when, the debt has become totally or partially worthless – a bad debt. The problem here is that the IRS often requires taxpayers to play a guessing game. If a taxpayer claims a bad debt loss when nonpayment is only probable rather than virtually certain, the IRS may disallow the loss as premature because there is some possibility of repayment in a later year. On the other hand, if the taxpayer waits until repayment is clearly hopeless, the IRS may maintain that the debt was really worthless in an earlier year and that the loss should have been taken then.

Because of potential statute of limitations problems, most tax advisors generally recommend that you claim a loss as soon as you can reasonably argue that it is worthless. A number of facts might indicate worthlessness, including the debtor's bankruptcy, but no one of them is decisive; it is the totality of circumstances that is determinative.

Once you establish that a bad debt exists, the business or nonbusiness nature of the debt decides the outcome. As you might expect, a business debt must be created or acquired, or become worthless, in the course of your trade or business. If you conduct a business in the form of a corporation, generally any debt held by the corporation is a business debt. Any debt not falling into the business category is a nonbusiness debt.

What are the differences in handling business versus nonbusiness debt? You can take a loss on a business bad debt as soon as you can establish partial worthlessness, but a nonbusiness bad debt must be completely worthless before you can take a loss. Business bad debts are deductible as ordinary losses in full against your other income, but nonbusiness bad debts are subject to the limitations on capital losses.

This is a complex topic, and our discussion is meant to give only a basic overview of the tax rules involved. Contango does not provide tax advice – that’s your tax preparer’s job – but part of our role as financial advisor is to provide information about issues of general application. Although your tax preparer can guide you through the details of claiming bad debts, please feel free to contact your Contango advisor to discuss whether you might be in a situation where these rules could affect you.

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