CPA

Practice **Advisor**

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Oct. 28, 2015

(This is part of our series of "sweet 16" year-end tax planning ideas.)

From a business perspective, there's practically nothing worse than providing goods or services to a customer or client and not getting paid. Or maybe you've made loans to vendors or suppliers that haven't been repaid. It can take a long time to get your money, or even part of it, and sometimes you still come up empty. At least you may be able to take some solace by claiming a bad business debt deduction on your tax return.

But bad business debt write-offs are hardly a slam-dunk. To qualify for federal income tax relief, you must be able to show that the debt is worthless. Fortunately, by ramping up your collection efforts at the end of the year, you can secure a deduction for 2015.

For starters, a cash-basis taxpayer may claim a business bad debt only if the amount that is owed was previously included in gross income. This applies to amounts owed from all sources of taxable income, including sales, services rents, and interest. If the accrual method of accounting is used, you generally report income as it is earned. Accordingly, you can only claim a bad debt deduction for an uncollectible receivable if you have previously included an uncollectible amount in income.

Next, you must establish that the debt is legitimate and can't be recovered from the debtor. This means you must make a "reasonable" effort to obtain payment. This doesn't necessarily mean you have to file a lawsuit against the debtor, but you can't simply make one telephone call and give up either. Find a happy medium.

Generally, the business is required to use the specific charge-off method for bad

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Totally worthless debts: If a debt becomes totally worthless in the current tax year, you can deduct the entire amount, less any amount deducted in an earlier tax year when the debt was only partly worthless.

Note that you don't have to make an actual charge-off on your books to claim a bad debt deduction for a totally worthless debt. However, if you don't and the IRS later rules the debt is only partly worthless, you won't be allowed a deduction for the debt in that tax year. That's because a deduction of a partly worthless bad debt is limited to the amount actually charged off.

Even though it will be winter soon, now is the time to spring into action. For instance, you might start with phone or email contacts, then issue a series of dunning letters if that doesn't work and even follow up by hiring a collection agency. Do what you can to bring the money in. If all else fails, you have the tax deduction in your hip pocket.

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