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loan to a client or bad credit sales to customers or suppliers. Non-business debt results ...

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Bad Debt. Some would ask, “Is there any other kind?”

In the tax world, there are two kinds of bad debt: business bad debt and non-business bad debt. Business debts result from doing business, such as a worthless loan to a client or bad credit sales to customers or suppliers. Non-business debt results from personal investments, such as lending money to friends and other activities that have nothing to do with a trade or business. Both have the potential to be deducted from your taxes, but in very different ways.

The difference is illustrated in a recent US Tax Court case that centers on Kaylan

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not covered by insurance. She maintained that the money was taken under false pretenses, and therefore stolen. In this case, the investor was not able to prove that the money had been taken with fraudulent intent.

“Unfortunately, Riley’s testimony about her friend’s new car and home improvements didn’t prove he lied about his use of the money because there are other explanations for how he got that money,” said enrolled agent Sherrill Trovato of Fountain Valley, CA. “The evidence offered didn’t support that he made false representations, and without that proof, she didn’t win in court.”

Fortunately for Riley, she still has another avenue to take this loss as a deduction: non-business bad debt. Non-business bad debts can be deducted as short-term capital losses, provided certain strict requirements are met:

- It’s a legitimate loan, and not a gift;
- Cash was loaned to someone who did not repay it;
- The loan is never going to be repaid.

Most people don’t know that loaning money to a deadbeat friend or relative can actually be a tax deduction. That’s why consulting with a licensed tax professional can save you money. Make sure you get all the credits and debits you are entitled to by speaking with an enrolled agent. Enrolled agents (also known as “EAs”) hold IRS’s most expansive license, which is earned by passing a stringent three-part test on taxation. EAs must comply with a code of ethics and complete annual continuing education in order to maintain their credential. Find an EA in your area on the searchable directory at www.EAtax.org.

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