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BY RICH SHAVELL

Deducting Bad Debts for Tax Purposes: A Primer

Collectively, the employees of a construction company work hard to perform work and provide services for which payment is deserved. Invoiced amounts are recorded as accounts receivables (A/Rs), recognized as income, and should be converted into cash. But the A/Rs are not always received.

If and when amounts owed to a company are not paid, then the unpaid amounts can (at least) be deductible as bad debts for tax purposes. There are several issues to consider:

- Accounting method
- Business vs. nonbusiness debt
- Establishing worthlessness
- Partial worthlessness
- Deductions where the customer files for bankruptcy
- Statute of limitations
- Tax benefit rule
- Related party loans

As has been the purpose of this Tax Technique column, the primary focus of this article is on the impact to the contractor being taxed as an S corporation.

Accounting Method

First, consider whether a taxpayer recognizes income for tax purposes on the accrual or cash method of accounting. Under the cash method, income is recognized when the amounts are received. If the taxpayer has not yet recognized the income, then there is no bad debt to deduct. Until income is recognized, there is zero basis in the asset (the receivable). In using the accrual method of accounting, income is recognized when an invoice is sent to a customer and a corresponding receivable is recorded on the books.

A common question from a cash method contractor is, "Why don't I get a bad debt write off when an A/R goes bad?" Since the receivable was never included in the income for tax purposes, there is zero basis and nothing to write off. In essence, the act of not including the receivable in income until it is actually received *is* the tax benefit to the cash method contractor. The accrual method taxpayer recorded income when the amounts were invoiced and is entitled to the bad debt deduction because the amounts were already included as income.

Business vs. Nonbusiness Debt

A fundamental issue is the nature of the debt: business or nonbusiness. Only business bad debts are immediately and fully deductible against ordinary income[1] whereas nonbusiness bad debts are reportable as short-term capital losses.[2] Short-term capital losses can only offset other capital gains and are limited, to the extent the losses exceed the gains, to an annual deduction of $3,000.[3]

The defining criteria for business debt are:[4]

1) Debt that is incurred or acquired in the course of a taxpayer's business

2) A bad debt whose effects are felt by a taxpayer's business

Treasury Regulations attempt to further clarify the second criterion: In order for a bad debt to be considered a business debt (whose effects are felt by a taxpayer's business), at the time of worthlessness, there must be some proximate relation to the conduct of the trade or business.[5] The U.S. Supreme Court established a standard of "dominant motivation rather than significant motivation"[6] in evaluating a debt's proximate relation to the conduct of business. If a debt does not meet this standard, then the debt in question is considered nonbusiness and subject to the capital loss limitations discussed earlier.

Under normal circumstances, examples of typical bad debts include sales to customers on credit, business loans and guarantees, and loans to suppliers, distributors, and employees.

Customer A/Rs are the most common type of bad debt because they are sales to customers on credit for goods or services that have been sold but have yet to be paid. For these customer sales, the proximate relation to the conduct of the contractor's trade or business is obvious.

Establishing Worthlessness

Generally, a bad debt becomes worthless when there is no reasonable basis in fact or hope that repayment will occur. The basic timing issue is *when* a debt becomes worthless. The contractor considers all pertinent evidence, including the value of any collateral, "securing [of] the debt, and the financial condition of the debtor."[7]

Worthlessness is best established by an identifiable event showing the loss of value of the debt. This can occur on or prior to the date the debt is due. The contractor can establish worthlessness by suing the debtor, winning a judgement, and then showing that the judgement – and corresponding debt – is uncollectible. If circumstances indicate a debt to be uncollectible and worthless, and that any legal action to collect the debt would in all probability not result in collection, then these facts are generally sufficient to justify the bad debt deduction as previously indicated. According to Treasury Regulation §1.166-2(b):

"Legal action not required. Where the surrounding 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 judgement, a showing of these facts will be sufficient evidence of the worthlessness of the debt for purposes of the deduction under section 166."[8]

Documentation supporting and clearly displaying the contractor's collection endeavors is helpful in the event of an IRS audit (i.e., if the IRS raised the issue during audit). Correspondence to/from the debtor and also to/from the contractor's attorneys should be maintained. The bottom line is that the contractor will generally need to take some action to support that it has attempted collection. This can simply be proof that form letters (or e-mails) were sent to the debtor and that some legal action was considered.

Total or Partial Worthlessness

Unlike a nonbusiness bad debt, a contractor can take a business bad debt deduction for partial worthlessness.[9] The contractor needs to show that partial worthlessness occurred and the amount deducted for partial worthlessness does not exceed the amount charged on the company's financial statements or internal books.[10]

For example, assume Corporation X in 2018 has a $100,000 outstanding receivable from Entity Y. Corporation X also has another receivable on the books from 2017 for $150,000 from Entity Z. Corporation X has already recognized the income from both of these receivables. Corporation X has been attempting to collect the $150,000 from Entity Z. In May of 2019, Entity Z files for bankruptcy, eliminating any opportunity to collect any of the outstanding receivable.

Bankruptcy "is generally an indication of the worthlessness of at least a part of an unsecured and unpreferred debt."[11] In some bankruptcy cases, a debt may become worthless before the conclusion of the bankruptcy process. In other cases, it is only when a final settlement through the bankruptcy court has been reached that the debt becomes fully worthless. In either case, the fact that bankruptcy proceedings have been initiated indicates that, at a minimum, there is partial worthlessness.

For the aforementioned example, it may be the same tax year as when proceedings commence, or possibly the following tax year when the bankruptcy proceedings are finalized and the final result for the debt is clearly determined. At finalization of the bankruptcy proceedings, the receivable from Entity Z is technically ***totally worthless*** unless, for example, ongoing payments are to be received by decree of the bankruptcy court.

From a practical perspective, in most cases, contractors facing a customer who has filed for bankruptcy generally receives very little for their unsecured A/R on a percentage basis, if they get anything at all. In many cases, contractors treat the notice of bankruptcy as the event indicating that the A/R is worthless and will not be paid.

Consider the following example. In 2019, Contractor X learns that Entity Y does not have sufficient cash flow to remit their payables and there is no way that they can pay Contractor X the full amount owed. The two parties come to an agreement that $65,000 of the original valued $100,000 receivable will be paid. Treasury Regulation §1.166-3(a)(2)(i) states: "If, from all the surrounding and attending circumstances, the district director is satisfied that a debt is partially worthless, the amount which has become worthless shall be allowed as a deduction…but only to the extent charged off during the taxable year." In understanding that the $35,000 of the remaining receivable will not be paid, the contractor writes off the $35,000 portion of the receivable and deducts it for tax purposes as a bad debt.

Note that a contractor is not required to claim a deduction for partial worthlessness.[12] In essence, this is an election. In some cases, it may be desirable to wait until full worthlessness can be documented. For example, maybe for tax purposes, the contractor doesn't need the tax deduction or the write off on the books. In fact, this may be a decision that can be made after year-end and treat it as a tax planning opportunity concluded after year-end.

Special Statute of Limitations

Sometimes it is difficult to prove if a debt became worthless in one particular year. Upon audit, if the IRS determines that the worthlessness of the debt happened in an earlier year than when the deduction is taken, then the deduction could be lost due to the three-year statute of limitations for filing a refund claim. The earlier year's tax return would need to be

amended in order to file for the refund claim, but this may be precluded because the statute has run. Important to note: the statute of limitations for claiming credits/refunds for bad debts is ***seven years***, rather than the three years usually permitted.[13] The practical approach is to consider claiming the deduction in the earliest year for which adequate documentation is available.

Consider the earlier discussion about waiting until full worthlessness is determined. Accordingly, careful scrutiny of the underlying documentation supporting partial and full worthlessness may be paramount to avoid unwanted ramifications if the IRS later scrutinizes the deduction during an audit.

Tax Benefit Rule

In the situation where a contractor takes a bad debt deduction for tax purposes in one year and then receives all or a portion of the written off receivable in a later tax year, then taxable income is the result. Under the tax benefit doctrine,[14] the prior year's return cannot be amended to correct the bad debt deduction originally taken. The income (the bad debt recovery) for the current year should not exceed the earlier year's deduction.[15]

For example, Contractor X wrote off a bad debt for $35,000 in 2017. Later, the customer makes a financial recovery and unexpectedly, in 2019, a check is received by Contactor X for $25,000 of the $35,000 amount previously deducted as a bad debt. In 2019, Contractor X reports the $25,000 as income. An amended return for 2017 is not needed.

Financial Statements & Audits

For financial statements prepared under generally accepted accounting principles (GAAP), the contractor may report debts differently than for tax purposes. Generally, there is no conformity requirement that what is deducted for tax purposes must correspond to your GAAP financial statements. As noted above, there is a conformity "constraint" for tax deduction purposes for partial worthlessness.

For GAAP purposes, the contractor typically analyzes its year-end A/R and writes off what is not collectible as bad debts. The contractor may also record a reserve ("allowance") for doubtful accounts as a contra-asset and record a corresponding bad debt expense. The portion of the bad debt expense represented by the reserve is a difference for tax purposes and is not tax deductible.

For example, consider the contractor that has an annual audit for banking or surety purposes. The outside auditor draws a sample of the year-end receivables and sends confirmations to customers to conclude whether the receivables are "good," meaning that they actually exist, the amount is accurate, etc. The auditor may also consider subsequent receipts against the sampled receivables that are received by the contractor early in the following year during the audit process, for example, in early 2019 for 2018 balances.

If sufficient evidence is not gathered to indicate that a sufficient portion of the sampled receivables are "good," then the auditor may be faced with the necessity of recommending an adjustment to increase the reserve.

This additional reserve amount will increase the bad debt expense, thereby decreasing net income on the financial statements, and it is not deductible for tax purposes. Moreover, the increased reserve, where the sampled receivables are not fully supported, is not based on specific A/R balances to write off. This is a computed amount generally based on the percentage of the sample that is not "good." This is usually not a good result for the contractor; the CFM should always endeavor to assist the auditor in getting the necessary customer documentation to avoid a financial statement deduction based on a reserve that is not deductible for tax purposes.

Related Parties Loans

While a bad debt deduction by an S corporation for debt owed to the corporation by a related party shareholder is permissible, documentation is paramount. First, the S corporation must show that there is an actual bona fide debt.[16] If there is no bona fide debt owed by the shareholder to the entity, then the amounts received by the shareholder (merely recorded as a debit receivable on the books) could be a dividend distribution to the shareholder. This is the potential risk under IRS audit.

"Tax Implications of Debit Shareholder Loans" (in the July/August 2016 issue of *CFMA Building Profits*) discusses the tax ramifications of debit shareholder loans. As suggested in that article, related party debt should always be represented by a formal note with adequate commercial terms.

Of course, if a bad debt can be documented by the entity, the other side of the transaction would be that the shareholder who caused the bad debt may face cancellation of debt income (CODI).[17] Depending on that shareholder's specific circumstances, this may be taxable CODI if the amounts cannot be excluded at the shareholder level under complex insolvency rules.[18] The key point here is that a bad debt is feasible for the entity if fully documented.

Summary

It is tough reality that contractors are not always fully paid for work performed or money that has been lent, but the CFM should endeavor to ensure that the corresponding bad debt is deductible for tax purposes.

While this article provides the basics, the CFM should contact their tax advisor to optimize the timing and amount of the company's bad debt deductions. ■

Endnotes

1. IRC §166(d)(1)(A).
2. IRC §166(d)(1)(B).
3. IRC §1211(b).
4. Treas. Reg. §1.166-5(b).
5. Treas. Reg. §1.166-5(b)(2).
6. U.S. v. Generes ET UX., 29 AFTR 2d 72-609 (405 U.S. 93), (S Ct), 02/23/1972.
7. Treas. Reg. §1.166-2(a).
8. Treas. Reg. §1.166-2(b).
9. Treas. Reg. §1.166-3(a)(1).
10. Treas. Reg. §1.166-3(a)(2)(iii).
11. Treas. Reg. §1.166-2(c)(1).
12. E. Richard Meinig Co., 9 TC 976.
13. IRC §6511(d).
14. Hillsboro Nat. Bk. v. Comm., 51 AFTR 2d 83-874 (103 S.Ct. 1134), (S Ct), 03/07/1983.
15. IRC §111.
16. Paul L. Dunmire, TC Memo 1981-372.
17. IRC §61(a)(11).
18. IRC §108(a)(1)(B).

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