Naden/Lean, LLC

A PROFESSIONAL SERVICES COMPANY OF
CERTIFIED PUBLIC ACCOUNTANTS AND BUSINESS CONSULTANTS

How do I deduct a bad debt on my individual income tax return?

Nonbusiness creditors may deduct bad debts when they become totally worthless (i.e. there is no chance of its repayment). The proper year for the deduction can generally be established by showing that an insolvent debtor has not timely serviced a debt and has either refused to pay any part of the debt in the future, gone through bankruptcy, or disappeared. Thus, if you have loaned money to a friend or family member that you are unable to collect, you may have a bad debt that is deductible on your personal income tax return.

The fact that the debtor is a family member or other related interest does not preclude you from taking a bad debt deduction, provided that the debt was bona fide and that worthlessness has been established. A direct or indirect transfer of money between family members may create a bona fide debt eligible for the bad debt deduction. However, these transactions are closely scrutinized to determine whether the transfer is a bona fide debt or a gift.

Bona-fide debt and other requirements for deductibility

You may only take a bad debt deduction for bona-fide debts. A bona-fide debt is a debt arising from a debtor-creditor relationship based on a valid and enforceable obligation to repay a fixed or determinable sum of money. You must also have the present intention to seek repayment of the debt. Additionally, for a bad debt you must also show that you had the intent to make a loan, and not a gift, at the time the money was transferred. Thus, there must be a true creditor-debtor relationship.

Moreover, nonbusiness bad debts are only deductible in the year they become totally worthless (partially worthless nonbusiness bad debts are not deductible).

To deduct a bad debt, you must also have a basis in it, which means that you must have already included the amount in your income or loaned out your cash (for example, if your spouse has not paid court-ordered child support, you cannot claim a bad debt deduction for the amount owed as this amount was not previously included in your gross income).

Reporting bad debts

You can deduct nonbusiness bad debts as short-term capital losses on Schedule D of your Form 1040. On Schedule D, Part I, Line 1, enter the debtor's name and "statement attached" in column (a). Enter the amount of the bad debt in parentheses in column (f). If you are reporting multiple bad debts, use a separate line for each bad debt. For each bad debt, attach a statement to your return containing the following:

- A description of the debt, including the amount and date it became due;
- The name of the debtor, and any business or family relationship between you and the debtor:
- The efforts you made to collect the debt; and
- An explanation of why you decided the debt was worthless (for example, you can show the debtor has declared bankruptcy or is insolvent, or that collection efforts such as through legal action will not likely result in the debt being paid).

If you did not deduct a bad debt on your original income tax return for the year it became worthless, you can file a refund claim or a claim for a credit due to the bad debt. You must use Form 1040X to amend your return for the year the debt became worthless. It must be filed with 7 years from the date your original return for that year had to be filed, or 2 years from the date you paid the tax, whichever is later.

Note. If you deduct a bad debt and in a later year collect all or part of the money owed, you may have to include this amount in your gross income. However, you can exclude from your gross income the amount recovered up to the amount of the deduction that did not reduce your tax in the year you deducted the debt.

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