

Determining Worthlessness of Business and Non Business Debts

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Under IRC Section 166, there is allowed as a deduction any business debt which becomes worthless during the year. There is not an exact test to determine the worthlessness of a business debt during the taxable year. In one court case, the Board of Tax Appeals noted the definition of worthlessness in the dictionary as destitute of worth, having no value, useless and then required the company to establish that the debts written off were without value. Unfortunately, the court in this case stopped short of defining worthless bad debts for tax purposes.

Worthlessness is not defined in Treas. Reg. §1.166-2 but the regulation does speak to the evidence of worthlessness. Typically the determination as to the whether a debt is worthless at a particular time is a question of fact to be determined by the evidence available from all surrounding circumstances. The judicial standard is usually more practical than judicial. Courts typically have focused on “sound business judgment” as a standard for worthlessness. The deduction is allowed when the debt becomes worthless during the tax year, therefore it is not only important to document that the debt is worthless but also when it became worthless.

Under the specific write off method of deducting bad debts, a taxpayer is allowed a deduction for each debt that becomes partially (business debts only) or wholly worthless during the year. The burden of proving worthlessness is on the taxpayer and must be met by proving objective facts. Generally, the taxpayer must exhaust all the usual reasonable means of collection to establish worthlessness. When writing off the worthless debts, the taxpayer needs to document all efforts at collecting a debt, including demands made, discussions had with debtor and the debtor’s reasons for not paying the debt. If an attorney or a collection agency is hired to attempt to collect the debt, then the efforts of the third party should also be documented.

Factors that may be used to prove worthlessness are:

- the debtor’s serious financial reverses,
- insolvency,
- lack of assets,
- persistent refusals to pay on demand,
- ill health or death,
- disappearance,
- abandonment of business,
- bankruptcy,
- receivership, and
- the debt’s unsecured or subordinated status and expiration of the statute of limitations.

Factors that may be used against a finding of worthlessness are:

- the creditor’s failure to press for payment (especially if the debtor is a relative or friend),
- willingness to make further advances,
- availability of collateral or guarantees by third parties,
- the debtor’s earning capacity,
- minor defaults,
- payment of interest, and
- sluggish business conditions.

In the comparison of business bad debts and non business bad debts, the determination of worthless is the same. The distinguishing factor between business bad debts and non business bad debts is that business bad debts can be partially written off while non business bad debts have to completely written off as worthless to take the deduction.

There are a significant number of cases that have been litigated regarding the determination of worthlessness. Most cases are based on the insolvency of the debtor and the sound business judgment of the creditor. The worthlessness of bad debts does not require the creditor to be an eternal optimist about collecting bad debt, it requires the creditor to justify the write off due to worthlessness and be able to defend the amount with the facts and circumstances of the specific debt. Since the worthlessness of a bad debt is determined by the facts and circumstances surrounding the decision, it is beneficial for the taxpayer to retain as much information as possible supporting the conclusion that a debt is partially or completely worthless.

For more information about this and other tax-related issues, please contact Greg Heimkreiter at 513-768-6780 or gheimkreiter@cfscpa.com.

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