

OAKLAND BUSINESS & Finance

Return to when, what, how much of tax write-offs

MORE THAN MONEY

SID MITTRA
Ph.D.

your tax return? The answer will depend upon your particular facts and circumstances.

Debt

A "debt" is an unqualified promise to pay a fixed or determinable sum of money. Although no one factor is determinative, a promissory note generally must be issued in exchange for consideration. If repayment is not expected when the "loan" is made, there is no debt.

Bad Debts — A bad debt is de-

ductible for tax purposes, but its tax treatment depends upon whether it is characterized as a business or a non-business bad debt.

A business bad debt is a business debt that has become worthless. A business bad debt is a debt created or acquired in connection with the trade or business of the taxpayer claiming the deduction, or a debt the worthlessness of which is incurred in the taxpayer's trade or business. A business bad debt may be deducted without limitation from ordinary income in the year it becomes worthless. Any unused portion may be carried back as a net operating loss to offset ordinary income in previous years (thus creating tax refund opportunities). A business bad debt is deductible even if the debt is only partially worthless.

Example: Frank Jones, an employee (but not a shareholder) of XYZ Company, loaned \$15,000 to the company. Assume that Frank can establish that

1995, Frank can deduct \$10,000 in 1995 as a business bad debt because the loan was promissory to Frank's trade or business as an employee (i.e., the loan was made to protect his job).

It will generally be more difficult for an employee/shareholder of a company to claim a business bad debt deduction. Facts and circumstances — such as a signed note, maturity date, reasonable rate of interest, the employee's drawing of a salary, the fact that the loan is not unreasonable in relation to the salary, a company with a low debt-to-stock ratio, and ownership of a minority interest — all may strengthen the employee's case for claiming a business bad debt deduction.

A non-business bad debt is any bad debt other than a business bad debt. It is treated as a short-term capital loss — deductible to the extent of capital gains plus \$3,000 of ordinary income — and any excess may be carried forward and deducted in future years. Unlike business bad debts, non-business bad debts are de-

ductible only when they become totally worthless.

Example: Carol Green makes a \$15,000 loan to a friend, Pete Smith, which is a non-business bad debt. Assume that Carol can establish that one-third of the loan became worthless in 1995 and that the balance of the loan became worthless in 1996. Carol is not allowed any deductions until 1996 when the debt is totally worthless.

Guarantors of Bad Debts — When a guarantor must satisfy a loan which he or she has guaranteed, the guarantor is entitled to a bad debt deduction, and the rules for claiming the deduction are similar to those discussed above. If the guarantor is not in the business of guaranteeing loans or if the guaranteed loan is not related to the guarantor's trade or business, then he or she is entitled to deduct the loss only as a non-business bad debt.

Example: Jim White guaranteed two loans to his corporation — one from the bank for operating expenses and a second from a friend to keep the company in business. When the company de-

faulted, Jim made good on the guarantees and claimed a bad debt deduction. In such circumstances, the Tax Court held that the guarantee to the bank was made to protect Jim's investment (i.e., a non-business bad debt) while the guarantee to the friend was made to protect his salary and employment (i.e., a business bad debt).

Planning Tip — If you are forced to satisfy a guarantee obligation but do not have the cash available, you can immediately claim a bad debt deduction if you borrow the funds to satisfy the obligation, but you cannot do so if you sign a note promising to pay the debt in the future.

Worthless Securities

When a security (e.g., a stock or bond) that you own becomes completely worthless, you can deduct the loss in that year by filing your tax return as if you sold the stock without any sales proceeds on the last day of the tax year. As a rule (with one exception), you will recognize a capital loss (i.e., gener-

ally the amount paid) for the security.

Special Statute of Limitations — A loss is allowed only for the taxable year in which it occurs. If you determine that either a bad debt or a security became worthless in a previous year, or the IRS determines that the loss occurred in a year other than the one in which you deducted the loss, there is a special statute of limitations that generally permits you to file a refund claim for up to seven (the general rule is three) years from the date you filed your initial return.

These are just some thoughts to consider. Your tax advisor can provide more detailed information and should be consulted before any action is taken.

Sid Mittra, Ph.D., CFP, is professor of finance, Oakland University, Rochester Hills, and owner Mittra & Associates, a Troy financial consulting firm. Deloitte & Touche supplied material for this article.

BUSINESS MILESTONES

This column highlights promotions, transfers, hirings, openings and other key business news with Farmington-area connections. Send a brief biographical summary — including the towns of residence and employment and a photo, if possible, to: Business Editor, Farmington Observer, 33411 Grand River, Farmington 48335. The Observer's fax number is (810) 477-9722.

Michael Maali, of Farmington Hills joins Coopers & Lybrand's Detroit office as Business Assurance Manager of the Retail and Distribution Industries Group. He provides clients traditional assurance services as well as specialized retail industry consulting services.



David Tubolino of Farmington Hills has been appointed assistant vice president-manager of the

Amerisure Companies Michigan Region. Tubolino will be responsible for all commercial lines op-

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