

IRS Topic 453 – Bad Debt Deduction

If someone owes you money that you cannot collect, you may have a bad debt. For a discussion of what constitutes a valid debt, refer to [Publication 550, Investment Income and Expenses](#), and [Publication 535, Business Expenses](#). Generally, to deduct a bad debt, you must have previously included the amount in your income or loaned out your cash. If you are a cash basis taxpayer, you may not take a bad debt deduction for money you expected to receive but did not (for example, for money owed to you for services performed, or rent) because that amount was never included in your income. For a bad debt, you must show that you intended at the time of the transaction to make a loan and not a gift. If you lend money to a relative or friend with the understanding the relative or friend may not repay it, you must consider it as a gift and not as a loan.

There are two kinds of bad debts – business and nonbusiness.

Generally, a business bad debt is one that comes from operating your trade or business. You can deduct it on your business income tax return.

The following are examples of business bad debts (if previously included in income):

- Loans to clients and suppliers
- Credit sales to customers, or
- Business loan guarantees

A business deducts its bad debts from gross income when figuring its taxable income. You can deduct business bad debts in part or in full. You can claim a business bad debt using either the specific charge-off method or the nonaccrual-experience method.

All other bad debts are nonbusiness. Nonbusiness bad debts must be totally worthless to be deductible. You cannot deduct a partially worthless nonbusiness bad debt.

A debt becomes worthless when the surrounding facts and circumstances indicate there is no reasonable expectation of payment. To show that a debt is worthless, you must establish that you have taken reasonable steps to collect the debt. It is not necessary to go to court if you can show that a judgment from the court would be uncollectible. You may take the deduction only in the year the debt becomes worthless. You do not have to wait until a debt is due to determine that it is worthless.

Report a nonbusiness bad debt as a short-term capital loss on [Form 8949 \(PDF\)](#), *Sales and Other Dispositions of Capital Assets*, Part 1, line 1. Enter the name of the debtor and "bad debt statement attached" in column (a). Enter your basis in the bad debt in column (e) and enter zero in column (d). Use a separate line for each bad debt. It is subject to the capital loss limitations. A nonbusiness bad debt deduction requires a separate detailed statement attached to your return.

For more information on nonbusiness bad debts, refer to [Publication 550, Investment Income and Expenses](#). For more information on business bad debts, refer to [Publication 535, Business Expenses](#).

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