Tax & Business Alert

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BUSINESS OWNERS, YOUR BAD DEBTS MAY BE DEDUCTIBLE

If you hold a business-related debt that's become worthless or uncollectible, a "bad debt" deduction may allow you to cut your losses. But there are a few hoops to jump through.

BUSINESS OR NONBUSINESS?

Business bad debts generate ordinary losses; *nonbusiness* bad debts are reported as short-term capital losses. The latter can be used only to offset capital gains (plus up to $3,000 in ordinary income). Also, you can't take a deduction for *partially* worthless nonbusiness bad debts. They must be totally worthless to be deductible.

A business bad debt is a loss related to a debt that was either created or acquired in a trade or business or closely related to your trade or business when it became partly or totally worthless. Common examples include credit sales to customers for goods or services, loans to customers or suppliers and business-related guarantees.

Some debts are considered both business and nonbusiness (personal). For example, say you guarantee a loan on behalf of one of your best customers, who also is a friend. If your friend later defaults, the test for whether your loss is business or nonbusiness is whether your "dominant motivation" in making the guarantee was to help your business or your friend.

If a bad debt is related to a loan you made to your business, the IRS may deny a bad debt deduction if it finds that the loan was a contribution to capital.

To qualify for a bad debt deduction, the underlying debt must be bona fide. That is, you must have loaned the money or extended credit with the expectation that you would be repaid and with the intent to enforce collection if you weren't repaid. Proper documentation is key.

INCLUDED IN INCOME?

Not all bad debts are deductible. The purpose of the deduction is to offset a previous tax liability. So, you must have previously included the receivable in your income.

Typically, that's not the case with respect to accounts receivable if your business uses the cash-basis method of accounting. Cash-basis taxpayers generally don't

HANDLE ACCOUNTING FOR "CHARGE-OFFS" CAREFULLY

You can deduct a partially worthless portion of business debt, but only if that amount has been "charged off" for accounting purposes during the tax year. The IRS takes the position that simply recording an allowance or reserve for anticipated losses isn't enough. You must treat the amount as a *sustained* loss, which requires specific language in your books. Deductions for *totally* worthless debts don't require a charge-off. But it's a good idea to do so anyway because, if the IRS determines the debt was only partially worthless, it can disallow the deduction absent a charge-off.

report income until they receive payment. If someone fails to pay a bill, the business simply doesn't include that amount in income. Permitting a bad debt deduction on top of that would give the business a windfall from a tax perspective.

Accrual-basis taxpayers, on the other hand, report income as they earn it, even if it's paid later. So, a bad debt deduction may be appropriate to offset uncollectible amounts previously included in income.

PURSUING A DEDUCTION

Review your business debts to assess whether any became partially or totally worthless during 2019. If so, and if you're an accrual-basis taxpayer, we can help you pursue a deduction. ■

MAKING GIFTS TO LOVED ONES? DON'T FORGET TAX PLANNING

Many people want to pass assets to the next generation during their lifetimes, whether to reduce the size of their taxable estates, to help family members or simply to see their loved ones enjoy the gifts. If you're considering lifetime gifts, be aware that the type of assets you give can produce substantially different tax consequences.

MULTIPLE TYPES OF TAXES

Federal gift and estate taxes generally apply at a rate of 40% to transfers in excess of your available gift and estate tax exemption. Under the Tax Cuts and Jobs Act, the exemption has approximately doubled through 2025. For 2019, it's $11.4 million (twice that for married couples with proper estate planning strategies in place).

Even if your estate isn't large enough for gift and estate taxes to currently be a concern, there are income tax consequences to consider. Plus, the gift and estate tax exemption is scheduled to drop back to an inflation-adjusted $5 million in 2026.

ESTATE TAX IMPACT

If your estate is large enough that federal estate tax is a concern, consider gifting property with the greatest future appreciation potential. You'll remove that future appreciation from your taxable estate.

If estate tax isn't a concern, your family may be better off taxwise if you hold on to the property and let it appreciate in your hands. At your death, the property's value for income tax purposes will be "stepped up" to fair market value. This means that, if your heirs sell the property, they won't have to pay any income tax on the appreciation that occurred during your life.

Even if estate tax is a concern, you should compare the potential estate tax savings from gifting the property now to the potential income tax savings for your heirs if you hold on to the property.

INCOME TAX CONSIDERATIONS

You can save income tax for your heirs by gifting property that hasn't appreciated significantly while you've owned it. The beneficiary can sell the property at a minimal income tax cost.

On the other hand, hold on to property that has already appreciated significantly so that your heirs can enjoy the step-up in basis at your death. If they sell the

property shortly after your death, before it's had time to appreciate much more, they'll owe no or minimal income tax on the sale.

Don't gift investments that have declined in value. A better option is generally to sell them prior to death, so you can claim the tax loss. You can then gift the sale proceeds.

Capital losses can offset capital gains, and up to $3,000 of net capital losses can offset other types of income, such as from salary, bonuses or retirement plan distributions. Excess capital losses can be carried forward until death.

CHOOSE WISELY

No matter your current net worth, it's important to choose gifts wisely. Please contact us to discuss the gift, estate and income tax consequences of any substantial gifts you'd like to make. ■

ACT NOW TO SAVE 2019 TAXES ON YOUR INVESTMENTS

Do you have investments outside of tax-advantaged retirement plans? If so, you might still have time to reduce your 2019 tax bill by selling some investments — you just need to carefully select *which* investments you sell.

BALANCE GAINS AND LOSSES

If you've sold investments at a *gain* this year, consider selling some losing investments to absorb the gains. This is commonly referred to as "harvesting" losses.

If, however, you've sold investments at a *loss* this year, consider selling other investments in your portfolio that have appreciated, to the extent the gains will be absorbed by the losses. If you believe those appreciated investments have peaked in value, you'll essentially lock in the peak value and avoid tax on your gains.

REVIEW TAX RATES

At the federal level, long-term capital gains (on investments held more than one year) are taxed at lower rates than short-term capital gains (on investments held one year or less). The Tax Cuts and Jobs Act (TCJA) retained the 0%, 15% and 20% rates on long-term capital gains. But, through 2025, these rates have their own brackets, instead of aligning with various ordinary-income brackets. For example, for 2019, the thresholds for the top long-term gains rate are $434,551 for singles, $461,701 for heads of households and $488,851 for married couples.

But the top ordinary-income rate of 37%, which also applies to short-term capital gains, doesn't go into effect for 2019 until taxable income exceeds $510,300 for singles and heads of households or $612,350 for joint filers. The TCJA also retained the 3.8% net investment income tax (NIIT) and its $200,000 and $250,000 thresholds.

CHECK THE NETTING RULES

Before selling investments, consider the netting rules for gains and losses, which depend on whether gains and losses are long term or short term. To determine your net gain or loss for the year, long-term capital losses offset long-term capital gains before they offset short-term capital gains. In the same way, short-term capital losses offset short-term capital gains before they offset long-term capital gains.

You may use up to $3,000 of total capital losses in excess of total capital gains as a deduction against ordinary income in computing your adjusted gross income. Any remaining net losses are carried forward to future years.

CONSIDER EVERYTHING

Keep in mind that tax considerations alone shouldn't drive your investment decisions. Also consider factors such as your risk tolerance, investment goals and the long-term potential of the investment. We can help you determine what makes sense for you. ■