Business Bad Debts (slide 1 of 3)

- Specific charge-off method must be used
  - Exception: Reserve method is allowed for some financial institutions
- Deduct as ordinary loss in the year when debt is partially or wholly worthless
  - Cash basis taxpayer does not have bad debt deduction for unpaid receivables
Business Bad Debts (slide 2 of 3)

• Example:
  – Ted uses the accrual method of accounting
    • Ted sells inventory on account for $1,150
      – Buyer pays $150 down and makes no other payments
    • Ted has $1,000 bad debt deduction
Business Bad Debts (slide 3 of 3)

• Example:
  – Tara uses the cash method of accounting
    • Tara performs accounting services for $1,150
      – Client pays $150 down and makes no other payments
    • Tara has no bad debt deduction
Nonbusiness Bad Debts (slide 1 of 2)

- Specific charge-off method must be used
- Deduct as short-term capital loss in the year when amount of worthlessness is known with certainty
  - No deduction is allowed for partial worthlessness of a nonbusiness bad debt
Nonbusiness Bad Debts (slide 2 of 2)

- Related party (individuals) bad debts are generally suspect and may be treated as gifts
Classification of Bad Debts

• Individuals will generally have nonbusiness bad debts unless:
  – In the business of loaning money, or
  – Bad debt is associated with the individual’s trade or business

• Determination is made either at the time the debt was created or when it became worthless
Worthless Securities (slide 1 of 2)

- Loss on worthless securities is deductible in the year they become completely worthless
  - These losses are capital losses deemed to have occurred on the last day of the year in which the securities became worthless
• Example of worthless securities
  – On December 1, 2002, Sally purchased stock for $10,000. The stock became worthless on June 1, 2003. Sally’s loss is treated as having occurred on December 31, 2003. The result is a long-term capital loss.
Section 1244 Stock
(slide 1 of 3)

• Sale or worthlessness of § 1244 stock results in ordinary loss rather than capital loss for individuals
  – Ordinary loss treatment (per year) is limited to $50,000 ($100,000 for MFJ taxpayers)
    • Loss in excess of per year limit is treated as capital loss
Section 1244 Stock
(slide 2 of 3)

• Section 1244 loss treatment is limited to stock owned by original purchaser
• Corporation must meet certain requirements to qualify
  – Major requirement is limit of $1 million of capital contributions
• Section 1244 does not apply to gains
• Example of § 1244 loss
  – In 1994, Sam purchases from XYZ Corp. stock costing $150,000. (Total XYZ stock outstanding is $800,000.) In 2003, Sam sells the stock for $65,000.
  – Sam, a single taxpayer, has the following tax consequences:
    $50,000 ordinary loss
    $35,000 long-term capital loss
Losses of Individuals

• Only the following losses are deductible by individuals:
  – Losses incurred in a trade or business,
  – Losses incurred in a transaction entered into for profit,
  – Losses caused by fire, storm, shipwreck, or other casualty or by theft
Definition of Casualty & Theft (C & T)

- Losses or damages to the taxpayer’s property that arise from fire, storm, shipwreck, or other casualty or theft
  - Loss is from event that is identifiable, damaging to taxpayer’s property, and sudden, unexpected, and unusual in nature
  - Events not treated as casualties include losses from disease and insect damage
Definition of Theft

• Theft includes robbery, burglary, embezzlement, etc.
  – Does not include misplaced items
When Casualty & Theft Is Deductible

- Casualties: year in which loss is sustained
  - Exception: If declared “disaster area” by President, can elect to deduct loss in year prior to year of occurrence
- Thefts: year in which loss is discovered
Effect of Claim for Reimbursement

• If reasonable prospect of full recovery:
  – No casualty loss is permitted
  – Deduct in year of settlement any amount not reimbursed

• If only partial recovery is expected, deduct in year of loss any amount not covered
  – Remainder is deducted in year claim is settled
Amount of C&T Deduction

• Amount of loss and its deductibility depends on whether:
  – Loss is from nonpersonal (business or production of income) or personal property
  – Loss is partial or complete
Amount of Nonpersonal C&T Losses

- Theft or complete casualty (FMV after = 0)
  - Adjusted basis in property less insurance proceeds
- Partial casualty
  - Lesser of decline in value or adjusted basis in property, less insurance proceeds
### C&T Examples

- **Business and production of income losses**  
  (no insurance proceeds received)

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Nonpersonal C&T Losses

• Business, rental, and royalty properties
  – Deduction will be FOR AGI

• Employee business and investment properties
  – Deduction will be FROM AGI
    • Misc. itemized deduction subject to 2% of AGI limitation
Nonpersonal C&T Gains

• Depending on the property, gain can be ordinary or capital
• Amount of nonpersonal gains
  – Insurance proceeds less adjusted basis in property
Personal C&T Gains

- Net personal casualty gains and losses
  - If gains exceed losses, treat as gains and losses from the sale of capital assets
    - Short term or long term, depending on holding period
  - Personal casualty and theft gains and losses are not netted with the gains and losses on business and income-producing property
Personal C&T Losses

- Net personal casualty gains and losses
  - If losses exceed gains, C&T deduction will be FROM AGI (an itemized deduction)

- Amount of personal C&T losses
  - Lesser of decline in value or adjusted basis in property, less insurance proceeds
  - C&T Limitation
    - Each C&T occurrence is deductible to extent > $100, and aggregate of C&T losses for year must be > 10% AGI
Example of C&T Limitation
(slide 1 of 2)

- Karen (AGI = $40,000) has the following C&T (amounts are lesser of decline in value or adjusted basis):
  1. Car stolen ($6,000) with camera inside ($500)
  2. Earthquake damage: house ($2,000), furniture ($1,000)
Example of C&T Limitation
(slide 2 of 2)

• Example of C&T limitation (cont’d)
Karen has no insurance coverage for either loss:

1. $6,000 + 500 = $6,500 - 100 = $6,400
2. $2,000 + 1,000 = $3,000 - 100 = $2,900

Karen’s deductible C&T loss is $5,300
[$6,400 + 2,900 - (10% $40,000)]
Definition of research and experimental (R&E) expenditures

- Costs for the development of an experimental model, plant process, product, formula, invention, or similar property and improvement of such existing property
Three alternatives are available for R&E expenditures:

- Expense in year paid or incurred,
- Defer and amortize over period of 60 months or more, or
- Capitalize (deductible when project abandoned or worthless)

Credit of 20% of certain R&E expenditures available
Net Operating Losses
(slide 1 of 3)

- Carryover period
  - Must carryback to 2 prior years, then carryforward to 20 future years
    - May make an irrevocable election to just carryforward
    - When there are NOLs from two or more years, use on a FIFO basis
  - 3 year carryback is available for:
    - Individuals with NOL from casualty or thefts
    - Farming businesses and small businesses with NOLs from Presidential declared disasters
Net Operating Losses
(slide 2 of 3)

• Example of NOL carryovers
  – Ken has a NOL for 2003
  – Ken must carryover his NOL in the following order:
    • Carryback to 2001 and 2002, then carryforward to 2004, 2005, ..., 2023
  – Ken can elect to just carryforward his NOL
    • Carryover would be to 2004, 2005, ..., 2023
Net Operating Losses
(slide 3 of 3)

- Effect of NOL in carryback year
  - Taxpayer must recompute taxable income and the income tax
  - All limitations and deductions based on AGI must be recomputed with the exception of charitable contribution deduction
  - All credits limited by or based on the tax liability must be recomputed
If you have any comments or suggestions concerning this PowerPoint Presentation for West's Federal Taxation, please contact:

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