Tax and Business Alert™

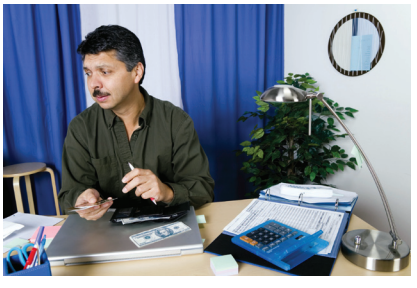
July 2010

Deducting Business Bad Debts

If debt collection is a problem for your business, deducting uncollectible (bad) debts from your tax bill may somewhat lessen the sting of simply writing them off. Here is some basic information on deducting business bad debts.

First, the debt must be legitimate. A bona fide debt arises from a debtor-creditor relationship and is based on a valid and enforceable obligation to pay a fixed or determinable amount of money. For debt creation, the business must be able to show that it was the intent of the parties at the time of the transfer to create a debtor-creditor relationship. In other words, the business must be able to show that at the time of the transaction, there was a real expectation of repayment, and there was intent to enforce the indebtedness.

For most businesses, it is common to incur uncollectible or worthless debts. Two types of bad debt deductions are allowed by the IRS: business bad debts and nonbusiness bad debts. Business bad debts give rise to ordinary losses that can generally offset taxable income on a dollar-for-dollar basis. Nonbusiness (personal) bad debts are considered to be short-term capital losses. Because there is a limitation on deducting capital losses, distinguishing business and nonbusiness bad debts is critical.



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Business bad debts generally originate as credit sales to customers for goods delivered or services provided. If a business sells goods or services on credit and the account receivable subsequently becomes worthless, a business bad debt deduction is permitted, but only if the revenue arising from the receivable was previously included in income.

Business bad debts can also take the form of loans to suppliers, clients, employees, and distributors. Additionally, a business bad debt deduction is allowed for any payments made in the capacity as guarantor if the reason for guaranteeing the debt was business related. Here, the guarantor's payment results in a loan to the debtor, and the taxpayer is generally allowed a bad debt deduction once the loan becomes partially or totally worthless.

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Tax Calendar

July 15—If the monthly deposit rule applies, employers must deposit the tax for payments in June for social security, Medicare, withheld income tax, and nonpayroll withholding.

August 2—If you have employees, a federal unemployment tax (FUTA) deposit is due if the FUTA liability through June exceeds $500.

—The second quarter Form 941 (Employer's Quarterly Federal Tax Return) is also due today. (If your tax liability is less than $2,500, you can pay it in full with a timely filed return.) If you deposited the tax for the quarter in full and on time, you have until August 10 to file the return.

August 16—If the monthly deposit rule applies, employers must deposit the tax for payments in July for social security, Medicare, withheld income tax, and nonpayroll withholding.

September 15—Third quarter estimated tax payments are due for individuals, trusts, and calendar-year corporations.

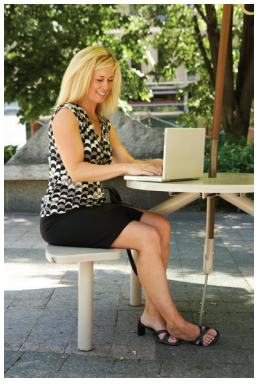
—If a five-month extension was obtained, partnerships should file their 2009 Form 1065 by this date.

—If a six-month extension was obtained, calendar-year corporations should file their 2009 income tax returns by this date.

—If the monthly deposit rule applies, employers must deposit the tax for payments in August for social security, Medicare, withheld income tax, and nonpayroll withholding.

Loans from IRAs Not Permitted

During this difficult economic period, taxpayers struggling financially should be wary of using IRA funds to supplement their income. In a recent real-life example, a taxpayer struggled to pay his business expenses, home mortgage, and family living expenses. To meet those needs, he withdrew funds from his Individual Retirement Account (IRA), which he intended to be a loan and not a distribution. He had previously borrowed money from his 401(k) plan to purchase a home.



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However, in this particular case, the Tax Court determined that unlike a loan from a qualified employer plan, i.e., 401(k) plan (which is permitted), a loan from an IRA to its owner is always a prohibited transaction. (There is no exception for loans from an IRA to its beneficiary.) The court's opinion added that, regrettably, there is no exception to the 10% early distribution tax for amounts used for business and living expenses. (This 10% penalty is in addition to the regular income tax due on the distribution.) Although the taxpayer's financial circumstances were not unusual during this tumultuous period, the tax code is sometimes unforgiving in its attempts at standardization.

Note: It is permissible to withdraw funds from an IRA and redeposit the same amount back in to an IRA within 60 days to avoid taxation and the 10% penalty.

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Worthlessness can be established when the business sues the debtor, and then shows the judgment is uncollectible. However, when the surrounding circumstances indicate a debt is worthless and uncollectible, and that legal action to collect the debt would in all probability not result in collection, proof of these facts is generally sufficient to justify the deduction.

Please contact us to discuss this tax-saving opportunity in more detail.

Retiree's State of Residency Tax Issues

When a person retires, he or she may decide to move to another state for a variety of reasons, such as living in a warmer climate, being closer to children or other relatives, avoiding state income tax, health reasons, or a combination thereof.

If the retiree's move is intended to be permanent, it is important that legal domicile be established in the new state. If domicile is not established, the retiree may be subject to income tax as a resident of both the old and new states. In addition, since each state has its own rules relating to residence and domicile, both states may try to impose taxes on the retiree even if he or she has established domicile in the new state, but has not adequately relinquished domicile in the previous state.

Furthermore, if the retiree dies without establishing domicile, both the old and the new states may claim jurisdiction over the retiree's estate.

The more time that elapses after the move and the more steps the retiree takes to establish domicile in the new state, the more difficult it will be for the old state to assert that the retiree resides or has domicile there.

The following steps tend to establish domicile in a new state:

- Register to vote in the new location.
- File a change of address form with the post office at the old location and change the address on documents, such as tax returns, wills, contracts, insurance policies, passports, and living trust agreements.
- Obtain a driver's license and register automobiles in the new location.
- Open and use bank accounts in the new location.
- Move items from safe deposit boxes in the old location to the new location.
- Purchase or lease a residence in the new state and sell the residence in the old state.
- If an income tax return is required, file a resident return in the new state and a nonresident return (or no return, if appropriate) in the old state.
- File for property tax relief under a homestead exemption (if any) in the new state.
- Move all items that make a house a home, such as mementos, heirlooms, sentimental items, trophies, collections, furniture, etc., to the new state.

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For many purposes, the location of property is determined by reference to state law, and may be somewhere other than where the property is physically located. The state in which the property is deemed to be located may assess income taxes (if any) on income or gains relating to the property. The state may also assess death and succession taxes, and that state will be where probate proceedings will occur when the individual dies. Furthermore, rules of that state will be used to determine whether testamentary instruments are valid and whether the terms of the instruments (such as the powers of a trustee) are legally enforceable.

The retiree's state of domicile generally determines the rules relating to the ownership and tax treatment of intangible personal property. Thus, if the retiree established domicile in a new state, that state's laws generally will apply to his or her intangible assets, such as bank accounts, stocks, bonds, notes, partnership interests, trust income rights, and insurance contracts. Interest income from a savings account, for example, will normally be taxed by the state of domicile, rather than the state in which the account is located.

Please contact us if you have questions on the tax ramifications of moving to another state or any other tax planning or compliance issue.

Distributions from Inherited IRAs

It is becoming increasingly common for individuals to inherit IRAs. By inheriting an IRA, we mean when you become entitled to some or all of the balance in a deceased account owner's traditional IRA or Roth IRA by virtue of being designated as an account beneficiary.

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In this scenario, you may think your share of the inherited IRA can be rolled over tax-free into your own IRA before the familiar 60-day deadline for rollovers has passed. While this seems like a very reasonable assumption, it is often incorrect. In fact, only the deceased IRA owner's surviving spouse is allowed to roll over distributions from an inherited IRA into his or her IRA. Nobody else can.

Thankfully, there is a way for nonspousal IRA beneficiaries to accomplish the same result as a tax-free rollover. A direct (trustee-to-trustee) transfer of an inherited traditional or Roth IRA into a (brand new) receiving IRA in the deceased account owner's name does not count as a rollover. The receiving IRA is a new IRA set up solely for the specific purpose of receiving the inherited balance from the deceased account owner's IRA. When the deceased account owner's IRA is a traditional IRA, the receiving IRA must be a traditional IRA. When the deceased account owner's IRA is a Roth IRA, the receiving IRA must be a Roth IRA.

By taking advantage of this procedure, the balance in an inherited IRA with a sole beneficiary who is a nonspouse can be transferred tax-free into a receiving IRA controlled by the beneficiary. Similarly, an IRA with several nonspousal beneficiaries can be divided up and transferred tax-free into several receiving IRAs, one for each beneficiary. That way, each beneficiary can pursue his or her own investment strategy with the inherited money.

Even though the beneficiary is effectively in control of the receiving IRA, the account must be kept in the name of the deceased IRA owner to indicate that it is an inherited IRA rather than an IRA that was originally set up to be owned by the beneficiary. For example, a receiving IRA might be titled "Coastal Bank, Custodian, for IRA of Joe T. Samson, Deceased, Fred Samson, Beneficiary."

To avoid adverse tax outcomes, please contact us before taking any distributions from an inherited IRA. That way, we can work with you to achieve the most favorable tax consequences for your inherited IRA money.