Abstract: This brief article highlights how businesses may be able to secure bad debt deductions. This tax treatment isn't automatic. A business must be able to show that the debt in question is worthless. The article explains the ins and outs of claiming a business bad debt for 2023.

How to secure a business bad debt deduction

Is your business having trouble collecting payments from clients or vendors? Years after the onset of the pandemic, some operations continue to feel the impact on business activity. It may be small solace, but at least you might be able to salvage a bad debt deduction on your tax return.

Caution: This tax treatment isn't automatic. Essentially, you must be able to show that the debt is worthless. That means you may have to ramp up your collection efforts. Fortunately, that could help your cash flow. If, however, it turns out that the debts are uncollectible, you may be able to secure a deduction. If you hope to take the deduction on your 2023 tax return, you'll have to get busy.

First, a cash-basis taxpayer may claim a business bad debt only if the amount that's owed was previously included in gross income. Second, as explained, a business must establish that the debt is legitimate and can't be recovered from the debtor. To this end, you must make a "reasonable" effort to collect the amount that's due.

This doesn't necessarily mean you have to file a lawsuit against the debtor. But you can't just make a single phone call either. Give it your best shot.

Often, the specific charge-off method (also called the direct write-off method) is used for writing off bad debts. In this case, you can deduct business bad debts that become either partially or totally worthless during the year.

For tax purposes, partially and totally worthless are defined as follows:

Partially worthless. The deduction is limited to the amount charged off on your books. You don't have to charge off and deduct your partially worthless debts annually, so you can postpone this to a later year. However, you can't deduct any part of a debt after the year it becomes totally worthless.

Totally worthless. If a debt becomes totally worthless in the current tax year, you can deduct the entire amount (less any amount deducted in an earlier tax year when the debt was partially worthless).

Note that you don't have to make an actual charge-off on your books to claim a bad debt deduction for a totally worthless debt. But if you don't record a charge-off and the IRS later rules the debt is only partially worthless, you won't be allowed a deduction for the debt in that tax year. Reason: A deduction of a partially worthless bad debt is limited to the amount actually charged off.

If you haven't started your collection efforts yet, time is short if you hope to claim a business bad debt deduction for 2023, so spring into action. For instance, you might start collection efforts through phone and email contacts. If that doesn't work, you may want to follow up with a series of letters — or even hire a collection agency. Finally, if all else fails, ask your tax advisor about the prospects of claiming a business bad debt deduction on your 2023 return.