Tax Impact

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Are bad business debts 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 don't assume a debt is deductible just because your odds of collecting are slim. There are a few hoops to jump through first.

Business or nonbusiness debt?

The first step is to determine whether a debt is a business or nonbusiness debt. This is important because business bad debts generate ordinary losses, while 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, unlike with business bad debts, you can't take a deduction for *partially* worthless nonbusiness bad debts. They must be totally worthless to be deductible.

To qualify for a bad debt deduction, the underlying debt must be bona fide.

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, business-related guarantees, and loans by those in the business of lending money.

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 happens to be a close personal friend. If your friend later defaults on the loan, 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 to help 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 actually a contribution to capital.

Is it bona fide?

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

Proving worthlessness

A debt is worthless when the surrounding facts and circumstances indicate there's no reasonable expectation of payment. Facts that may support this conclusion include the debtor's bankruptcy or insolvency, a sharp decline in the value of any collateral or, in the case of an individual debtor, the debtor's death or disappearance.

Often, the best evidence of worthlessness is showing that you've taken reasonable steps to collect the debt. That doesn't necessarily mean going to court if you can prove that a judgment would be uncollectible.

repaid. A written note or loan agreement can help establish your intent, although formal documentation isn't required if you have other evidence that shows the transaction was a legitimate loan and not a gift.

Did you include it in income?

Not all bad debts give rise to deductions. The purpose of the deduction is to offset a previous tax liability. That means 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 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.

Totally or partially worthless?

You can deduct the portion of a debt that has become partially worthless, 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 business's books.

Deductions for *totally* worthless debts don't require a charge-off. But it's a good idea to do so anyway. Why? Because if the IRS determines that the debt was only partially worthless, it can disallow the deduction absent a charge-off.

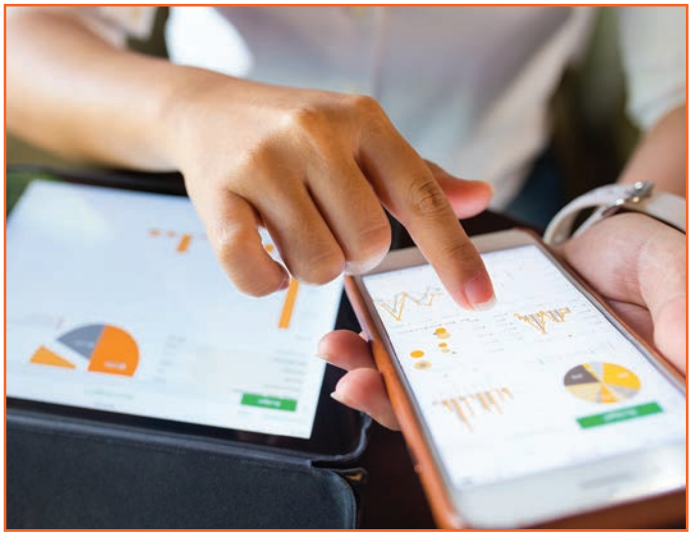
Keep in mind that a totally worthless debt must be deducted in the year it becomes totally worthless (which may be before it comes due). If you miss a deduction that should have been taken in an earlier year, you can claim the deduction by filing an amended return. But that's only if the statute of limitations for amended returns hasn't expired. If the proper year for deducting a bad debt is unclear, consider claiming the deduction as early as possible to ensure it isn't lost. You can always amend your return if future developments indicate that the deduction should be taken in a later year.

Review your debts

As you work to file your tax return, review your business debts to assess whether any became partially or totally worthless during 2017. If so, be prepared to document your efforts to collect the debt and provide other proof of worthlessness. (See "Proving worthlessness" above.) ■

Tax planning for investors: Income vs. growth

Whether you invest for income (dividends and interest), growth (price appreciation) or total return (a combination of income and growth), it's important to assess the impact of taxes on your portfolio. Here are some of the tax issues you should consider.



Not all dividends are created equal

One benefit of dividends is that they may qualify for preferable capital gains tax rates. For the 2017 tax year, the top rate is 20% for high-income taxpayers — individuals (other than heads of household, for whom the amount is $444,550) with income over $418,400 and joint filers (and those filing as a surviving spouse) with income over $470,700. For 2017, taxpayers with income under those thresholds enjoy either a 15% rate or, for those in the lowest two tax brackets, a 0% rate.

Keep in mind, however, that only "qualified dividends" are eligible for these rates; nonqualified dividends are taxed as ordinary income at rates as high as 39.6% for 2017. Qualified dividends must meet two requirements:

1. The dividends must be paid by a U.S. corporation or a qualified foreign corporation.
2. The stock must be held for at least 61 days during the 121-day period that starts 60 days before the ex-dividend date and ends 60 days after that date.

A qualified foreign corporation is one that's organized in a U.S. possession or in a country that has a current tax treaty with the United States, or whose stock is readily tradable on an established U.S. market. The ex-dividend date is the cutoff date for declared dividends. Investors who purchase stock on or after that date won't receive a dividend payment.

Timing is everything

One disadvantage of dividend-paying stocks (or mutual funds that invest in dividend-paying stocks) is that they *accelerate* taxes. Regardless of how long you hold the stock, you'll owe taxes on dividends as they're paid, which erodes your returns over time.

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When you invest in growth stocks (or mutual funds that invest in growth stocks), you generally have greater control over the timing of the tax bite. These companies tend to reinvest their profits in the company rather than pay them out as dividends, so taxes on the appreciation in value are deferred until you sell the stock.

Tax reform may change the equation

Keep in mind that tax reform may affect the benefits of income investing. Even if preferable rates for qualified dividends are retained, changes in individual income tax rates and brackets can have a significant impact. Suppose, for example, that tax rates are reduced and that the income threshold for the 20% rate for qualified dividends is lowered for 2018. If that happens, the gap between the tax rates on ordinary and dividend income would be narrowed, reducing the advantages of qualified dividends.

Seeing the big picture

There are many factors to consider — both tax and nontax — when selecting investments. Some investors seek dividends because they need the current income or they believe that companies with a history of paying healthy dividends are better managed. Others prefer to defer taxes by investing in growth stocks. And, of course, there's something to be said for a balanced portfolio that includes both income and growth investments.

Regardless of your investment approach, it's important to understand the tax implications of various investments so you can make informed decisions. And keep an eye on Congress so you can evaluate the potential impact of tax reform on your investment strategies. ■

Higher education is expensive!

Begin saving the tax-smart way with a Section 529 plan

When it comes to saving for college, parents and grandparents often turn to one of the most popular sections of the tax code: Section 529 college savings plans. Of all the vehicles available for college savings, 529 plans are perhaps the most versatile in some ways. They're available to anyone, regardless of income level. And they provide potentially significant income tax and estate planning opportunities. So if you're faced with the daunting task of financing a child's college education, a 529 plan is well worth considering.

ABCs of 529s

529 plans, sponsored by states, allow you to make cash contributions to a tax-advantaged investment account. Although contributions aren't tax deductible at the federal level, earnings can grow tax-deferred and may be withdrawn free of federal — and, generally, state — income taxes, provided they're used for qualified higher education expenses. These include tuition, fees, books, supplies and equipment, and certain room and board expenses. Nonqualified withdrawals are subject to taxes and a 10% penalty on the earnings portion.

Although most college savings plans are open to both residents and nonresidents of the state sponsoring the plan, there may be advantages to opening an account in your home state: possible state income tax deductions or other state tax breaks.

Perhaps the biggest advantage of 529 plans is that their contribution limits are much higher than

those for other tax-advantaged educational savings vehicles. The tax code doesn't specify a dollar limit; it simply requires plans to "prevent contributions … in excess of those necessary to provide for the qualified higher education expenses of the beneficiary." Limits vary, but in general they disallow additional contributions once the plan balance reaches a predetermined amount, which, depending on the plan, ranges from $235,000 to more than $500,000 per beneficiary.

Estate planning benefits

529 plans are designed to fund college expenses, but they also provide estate planning benefits. Contributions are considered completed gifts for purposes of gift and generation-skipping transfer (GST) taxes, but they're also eligible for the annual exclusion — which currently shields up to $15,000 per year ($30,000 for married couples) in gifts, to any number of beneficiaries, from gift and GST taxes without using up any of your lifetime exemptions.

What's more, a 529 plan allows you to "front-load" contributions. This means that you can use up to five years' worth of annual exclusions in one year. Suppose that a husband and wife open 529 plans for their two grandchildren, and that each plan has a $160,000 contribution limit. The couple can immediately contribute $150,000 (5 × $30,000) to each plan *free of gift and GST taxes.*

For estate tax purposes, 529 plans are a great tool. Contributions and future earnings are excluded from your taxable estate even though you retain a great deal of control over the funds. Typically, you can't place assets beyond the reach of estate taxes unless you relinquish control (by placing them in an irrevocable trust, for example). But with a 529 plan, you retain the ability to time distributions, to change beneficiaries or plans (subject to certain limitations) or even to revoke the plan and get your money back (again, subject to taxes and penalties).

Beware of the drawbacks

As great as 529 plans sound, they do have some drawbacks. One is that you're limited to the investment options the plan offers. Another is that you can change investment options only twice a year or if you change beneficiaries. But anytime you make a *new* contribution, you can choose a different investment option for that contribution.

Perhaps the biggest advantage of 529 plans is that their contribution limits are much higher than those for other tax-advantaged educational savings vehicles.

There are also a couple of estate planning drawbacks. First, if you front-load contributions, you can't make additional annual exclusion gifts to those beneficiaries for five years. Second, if you die within five years after making these contributions, a portion of them will be included in your taxable estate.

Begin saving sooner rather than later

With the cost of a college education skyrocketing, young parents should take the time to learn about the ins and outs of 529 plans. Contact your tax planning advisor to learn more. ■

File early, but not too early

If you're expecting a tax refund from the IRS, there are some good reasons to file your 2017 income tax return as early as possible. For one thing, the earlier you file, the sooner you'll get your refund. Plus, filing early helps thwart would-be identity thieves from snatching your refund before you do.

But don't file your return *too* early, especially if there's a risk it won't be accurate and complete. True, you can correct it later, but doing so may increase the chances of an audit, and if you end up owing more taxes than you originally reported and paid, you could be hit with interest and penalties.

Avoid filing until you've received all expected 1099 and K-1 forms. Form 1099, which reports various types of nonwage income, is due January 31, 2018, but it's not unusual for issuers to miss the deadline or for the deadline to be extended. And K-1 forms — which report your share of income from partnerships, S corporations and LLCs — may not be sent until their March 15, 2018, due date, or later if the due date of the return is extended. ■

File even if you can't pay

It's critical to file your tax return on time even if you're unable to pay some or all of the taxes due. Be sure to pay as much as you can with your return to minimize interest and penalties on late payments. It's also a good idea to consider filing Form 9465 — "Installment Agreement Request" — with your return to initiate the process of arranging a payment plan. ■

It's not too late for 2017 IRA contributions

If you're eligible to contribute to an IRA, remember that you can deduct contributions to a traditional IRA on your 2017 tax return provided you make them by April 17, 2018. Contributions sent by mail should be postmarked by that date. Be aware that the deadline applies regardless of whether you obtain an extension of time to file your return. However, if you have a SEP-IRA and obtain an extension, you can make contributions up until the extended due date and deduct them on your 2017 return.

For 2017, the contribution limit for a traditional IRA is $5,500 — $6,500 if you're 50 or older as of the last day of the year. If you're self-employed with a SEP-IRA, you can contribute as much as $54,000, depending on your income.

A couple of limitations to keep in mind: To contribute to an IRA you must have sufficient eligible compensation — such as wages, tips, commissions or net earnings from a trade or business — to cover the amount of your contribution (although the funds for the contribution can come from anywhere). Also, you're ineligible to contribute to a traditional IRA in the year you turn 70½ or any year thereafter. ■

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