

INTERNAL REVENUE SERVICE
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The Honorable Carl Levin
United States Senator
477 Michigan Avenue, Room 1860
Detroit, MI 48226

Dear Senator Levin:

This letter is in response to your inquiry dated January 28, 2000, on behalf of your constituent, Mr. . Mr. asked three questions concerning nonbusiness bad debts:

- (1) What documentation is required to establish a nonbusiness bad debt?
- (2) What documentation is required to show the debtor is unable to repay the debt?
- (3) What is the limitation on the amount of a bad debt deduction?

Although we do not have the specific facts of Mr. situation, I hope the following general information will be helpful.

Evidence of Loan Needed to Establish a Nonbusiness Bad Debt

Mr. must establish that he is a creditor rather than a donor. For example, he might possess a signed, notarized promissory note and might hold collateral (e.g., mortgage, chattel mortgage). If Mr. is related to the debtor, however, he should be prepared to rebut the Internal Revenue Service's (IRS) potential argument that his transfer of funds was a gift rather than a bona fide loan. In addition, he must establish his "basis" in the loan (e.g., amount lent to, and owed by, the debtor). In the case of a cash loan, Mr. should be prepared to provide checks cashed by the debtor and an amortization schedule, if applicable, showing any repayments by the debtor.

Evidence of Worthlessness Required to Show Debtor Cannot Repay Loan

Mr. _____ must establish, based on all the facts and circumstances, his loan became totally worthless during the taxable year. For this purpose, "worthless" means the debtor is unable to repay the loan. Unsuccessful attempts to collect a debt can indicate the debt is worthless. Documentation showing attempts to collect a debt may include a written demand for repayment, a contract with a collection agency, an engagement letter with an attorney, a court pleading, a judgment, a "proof of claim" in bankruptcy case, the debtor's financial statement or credit report, and the debtor's medical condition.

A loss on a nonbusiness debt is allowed only if and when the debt becomes totally worthless. No deduction is allowed for a nonbusiness debt that is recoverable in part during the taxable year. In determining whether a debt is worthless in whole or in part, the IRS will consider all pertinent evidence, including the value of the collateral, if any, securing the debt and the financial condition of the debtor. When circumstances show that a debt is worthless and uncollectible and that legal action against the debtor to enforce payment probably will not result in a recoverable judgment, then sufficient evidence of worthlessness exists to support a bad debt deduction.

Bankruptcy generally indicates the worthlessness of at least part of an unsecured and unpreferred debt (i.e., claims that can be discharged in bankruptcy). In some bankruptcy cases, a debt may become worthless before settlement; in others, the debt may become worthless only when a settlement has been reached. In either situation, the year a debt becomes worthless may be earlier than the year bankruptcy proceedings against the debtor are concluded. However, the bad debt deduction may only be taken in the year the debt becomes worthless.

Dollar Limit on a Bad Debt Deduction

A loss from any nonbusiness debt that becomes worthless within the taxable year is considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than one year ("short-term capital loss"). For individuals, losses from sales or exchanges of capital assets are allowed only to the extent of the gains from such sales or exchanges, plus (if losses exceed gains) the lower of (1) \$3,000 (\$1,500 in the case of a married individual filing a separate return), or (2) the excess of such losses over such gains. If the individual has a net capital loss that is not allowed for the tax year because of this limitation, the excess may be carried forward to the following tax year. Thus, if Mr. _____ has a loss from a nonbusiness bad debt, it is treated as a short-term capital loss for the year and, along with any other capital losses, is deductible to the extent of capital gains, plus \$3,000.

I hope the information in this letter is helpful to Mr. . If we may be of further assistance in this matter, please contact me or Mr. Leo F. Nolan II at (202) 622-4960.

Sincerely,

William A. Jackson
Acting Deputy Assistant Chief Counsel
(Income Tax & Accounting)