ACCOUNTS RECEIVABLE - BAD DEBT DEDUCTION

This paper discusses the effect of bad debt deductions on three different methods of accounting: cash basis tax return, accrual basis tax return, and accrual basis financial statement.

Example: If you have a service oriented business (i.e. Medical Practice) and in Year 1 you had the following results:

Billings – Amounts billed to clients for services provided during the year.	$1,000,000
Less: Collection/Deposits – Amounts received from clients during the year.	(600,000)
Less: Direct Write Offs – Bad accounts specifically identified and written off.	(260,000)
Remaining Accounts Receivable – Amounts to be collected next year.	$ 140,000
Estimated % of Remaining Accounts Receivable that will be uncollectable.	35%
Other Operating Expenses (Payroll, Rents, Utilities, Advertising, Supplies, Etc.) *1*	$440,000

1 because the purpose of this paper is to discuss BAD DEBT, all other operating expenses (depreciation, accounts payable, accrued expenses) are assumed to be equal under the different methods.

Using the above figures, your income under the various accounting methods would be:

Description	**Tax – Cash**	**Tax – Accrual**	**Financial Stmt**
Income	600,000	1,000,000	1,000,000
Expenses:			
BAD DEBT	-0-	260,000	309,000
Other Operating Expenses	440,000	440,000	440,000
Total Expenses	440,000	700,000	749,000
Taxable / Net Income	160,000	300,000	251,000

Income Tax Return – Cash Basis: Under the cash basis method of accounting, only amounts actually collected/deposited from your clients are reported as income; so you only report $600,000 even though you earned $1,000,000 – you have essentially taken a $400,000 deduction by reporting only the billings that you actually collected/deposited which is why the IRS only allows this method for certain taxpayers (generally “smaller” businesses).

Income Tax Return – Accrual Basis: Under the accrual basis of accounting, you report income when it was earned regardless of whether or not you collected it. Under the accrual basis method you will notice that all the billings have been included in income, and the IRS has allowed a BAD DEBT deduction of $260,000. In order to deduct the BAD DEBTs, generally you need to show that: (1) the amounts being written off were included in income, and (2) you specifically identified the bad accounts and wrote them off after unsuccessfully trying to collect them.

Financial Statement – Accrual Basis: The financial statement accrual calculation differs a little bit from the IRS in that the IRS only allows BAD DEBTs that were specifically identified and written off, while Generally Accepted Accounting Principals (GAAP - which is what your financial statement is prepared on) requires you to take the remaining accounts receivable of $140,000 and estimate the remaining BAD DEBT. So if your ending AR balance is $140,000 and you estimate that 35% of the $140,000 will be uncollectable then you will end up with BAD DEBT of $309,000 which is the $260,000 already written off plus $49,000 of the remaining $140,000 estimated to be bad.

Conclusion: You will notice that the Taxable Income from the Cash Basis method of $160,000 is substantially less than the Taxable Income from the Accrual Basis of $300,000; almost half as much. This is why many taxpayers use the cash basis method of accounting for income tax purposes and the accrual method for their financial statements. It is important to remember that if you are taxed under the cash basis method of accounting, there is no such thing as a BAD DEBT deduction as the income was never included in income to start with. The IRS is always on the look out for issues to audit and deducting bad debt on a cash basis tax return is a good way to flag your return.