



Federal Tax ADVISORY ■

AUGUST 1, 2017

Partial Worthlessness

While we wait to learn whether the Section 385 regulations will be withdrawn or changed, it is useful to recall some of the basic rules of dealing with debt. Even related-party debt can sometimes run into payment troubles. The related creditor will tend to let the debtor's defaults go, or will "lend" the interest that is not paid by accruing it and adding it to the principal. Of course the IRS knows that, and it is one of the reasons for the Section 385 regulations.

Even if the creditors are not required by regulations to prove proper enforcement actions, they should think about it. If a related debtor can't pay, then the parties should consider restructuring the loan. A third-party financial analysis may be useful if the loan is large enough. Adding a guarantee by another related party may be advisable. The one thing not to do is to ignore the failure to service the debt.

An option that is sometimes overlooked is claiming a deduction for partial worthlessness. That will not be possible for debts in the consolidated group, but can occur for cross-border or brother-sister debt.

While a creditor may have no choice when to report total worthlessness, claiming partial worthlessness is discretionary: the creditor does not have to do it, or do it at any particular time. But if the creditor decides to claim partial worthlessness, it must actually write off that much of the debt for book purposes. Sometimes the creditor resists such a write-off because of its effect on reported earnings, internally or externally.

Generally, a partial worthlessness write-off requires some proof that that part of the debt will not be paid in the reasonably foreseeable future. That is a hard pill for most groups to swallow because it sometimes amounts to admission that the debtor's business will fail.

A compromise solution is for the creditor to acquire financial equity support from another related party after the write-off of part of its debt. That can explain why the charge-off is partial and not a complete worthlessness.

The advantage of a partial worthlessness deduction is that it produces an ordinary loss. In contrast, if the creditor recapitalizes debt into stock, it may have a reorganization, or if it accepts partial payment for the whole debt, it will recognize a capital loss.

For more information, please contact [Jack Cummings](#) at 919.862.2302.

If you would like to receive future *Federal Tax Advisories* electronically, please forward your contact information to FederalTax.Advisory@alston.com. Be sure to put “**subscribe**” in the subject line.

Click [here](#) for Alston & Bird's Tax Blog.

If you have any questions or would like additional information, please contact your Alston & Bird attorney or any of the following:

Federal Tax Group

Sam K. Kaywood, Jr.
Co-Chair
404.881.7481
sam.kaywood@alston.com

Edward Tanenbaum
Co-Chair
212.210.9425
edward.tanenbaum@alston.com

George Abney
404.881.7980
george.abney@alston.com

Brian D. Harvel
404.881.4491
brian.harvel@alston.com

Ashley B. Menser
919.862.2209
ashley.menser@alston.com

John F. Baron
704.444.1434
john.baron@alston.com

L. Andrew Immerman
404.881.7532
andy.immerman@alston.com

Matthew Moseley
202.239.3828
matthew.moseley@alston.com

Henry J. Birnkrant
202.239.3319
henry.birnkrant@alston.com

Stefanie E. Kavanagh
202.239.3914
stefanie.kavanagh@alston.com

Danny Reach
704.444.1272
danny.reach@alston.com

James E. Croker, Jr.
202.239.3309
jim.croker@alston.com

Brian E. Lebowitz
202.239.3394
brian.lebowitz@alston.com

Heather Ripley
212.210.9549
heather.ripley@alston.com

Jasper L. Cummings, Jr.
919.862.2302
jack.cummings@alston.com

Clay A. Littlefield
704.444.1440
clay.littlefield@alston.com

Michael Senger
404.881.4988
michael.senger@alston.com

Scott Harty
404.881.7867
scott.harty@alston.com

ALSTON & BIRD

WWW.ALSTON.COM

© ALSTON & BIRD LLP 2017

ATLANTA: One Atlantic Center ▪ 1201 West Peachtree Street ▪ Atlanta, Georgia, USA, 30309-3424 ▪ 404.881.7000 ▪ Fax: 404.881.7777

BEIJING: Hanwei Plaza West Wing ▪ Suite 21B2 ▪ No. 7 Guanghua Road ▪ Chaoyang District ▪ Beijing, 100004 CN ▪ +86 10 8592 7500

BRUSSELS: Level 20 Bastion Tower ▪ Place du Champ de Mars ▪ B-1050 Brussels, BE ▪ +32 2 550 3700 ▪ Fax: +32 2 550 3719

CHARLOTTE: Bank of America Plaza ▪ 101 South Tryon Street ▪ Suite 4000 ▪ Charlotte, North Carolina, USA, 28280-4000 ▪ 704.444.1000 ▪ Fax: 704.444.1111

DALLAS: 2828 North Harwood Street ▪ 18th Floor ▪ Dallas, Texas, USA, 75201 ▪ 214.922.3400 ▪ Fax: 214.922.3899

LOS ANGELES: 333 South Hope Street ▪ 16th Floor ▪ Los Angeles, California, USA, 90071-3004 ▪ 213.576.1000 ▪ Fax: 213.576.1100

NEW YORK: 90 Park Avenue ▪ 15th Floor ▪ New York, New York, USA, 10016-1387 ▪ 212.210.9400 ▪ Fax: 212.210.9444

RESEARCH TRIANGLE: 4721 Emperor Blvd. ▪ Suite 400 ▪ Durham, North Carolina, USA, 27703-85802 ▪ 919.862.2200 ▪ Fax: 919.862.2260

SAN FRANCISCO: 560 Mission Street ▪ Suite 2100 ▪ San Francisco, California, USA, 94105-0912 ▪ 415.243.1000 ▪ Fax: 415.243.1001

SILICON VALLEY: 1950 University Avenue ▪ 5th Floor ▪ East Palo Alto, California, USA, 94303-2282 ▪ 650.838.2000 ▪ Fax: 650.838.2001

WASHINGTON, DC: The Atlantic Building ▪ 950 F Street, NW ▪ Washington, DC, USA, 20004-1404 ▪ 202.239.3300 ▪ Fax: 202.239.3333