



## Federal Tax ADVISORY ■

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### Partial Worthlessness

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While we wait to learn whether the Section 385 regulations will be withdrawn or changed, it is useful to recall some of the basic rules of dealing with debt.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.

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