

THE VALUE OF WORTHLESSNESS

Nearly every business has felt the impact of the financial crisis that began in fall 2008. This dark economic cloud might have a silver lining in the U.S. tax code, however, which contains provisions to help companies and their owners capture needed value by taking deductions for a variety of worthless assets. Talk to your tax adviser if you believe you could qualify for these tax benefits:

Losses for Worthless Assets. A company can deduct its basis in any asset that became wholly worthless during the taxable year. Evidence of worthlessness must come from a completed transaction establishing the lack of value, such as the retirement of an obsolete piece of equipment or the discarding of inventory that will not sell. A mere bookkeeping entry is not sufficient evidence to establish worthlessness.

Abandonment of Worthless Property. Abandoning property will generate a loss equal to the company's basis in the property if the company presents evidence of an intent to abandon the property and demonstrates overt acts of abandonment. Giving up legal title to the property is not necessarily required. The company must make a commercially reasonable determination of the property's worthlessness. In certain circumstances, partners can abandon worthless partnership interests.

Bad-Debt Deduction. A creditor who no longer has a reasonable expectation of receiving whole or partial repayment of a debt obligation (including customer accounts receivable) might be able to take a bad-debt deduction, either as an ordinary loss or as a short-term capital loss, depending on the circumstances. In general, the deduction is limited to the creditor's adjusted basis in the obligation and must be taken in the year in which the debt becomes wholly or partially worthless. Special rules apply to determining the amount of the loss for worthless accounts receivable. The company's accounting method (cash basis vs. accrual) might affect whether it can take such deductions. The facts and circumstances in evidence at year end determine whether a debt is wholly or partially worthless. A business debt need only be partially worthless to be deducted, but the worthless portion must be written off the books as an asset. In contrast,

nonbusiness debts must be wholly worthless to be deducted. Owners may claim bad-debt deductions for loans they made to the company, but the overall facts and circumstances will determine whether the transaction is really debt or an additional equity contribution.

Losses for Worthless Stock. An individual shareholder can claim a capital loss for stock that became worthless during the taxable year. Similarly, a parent corporation can claim a loss (possibly ordinary, not capital) for its investment in a subsidiary. Liquidating an insolvent subsidiary (such as by converting it to a disregarded entity) might be a way to generate a worthless stock loss.

Payments to Terminate Leases or Contracts. In general, payments that lessees make to lessors to terminate a lease (of real or tangible personal property) are deductible expenses. Lease modifications and integrated transactions in which a lessee enters into a subsequent lease are not deductible, though. Payments made to terminate other forms of burdensome or unfavorable contracts are deductible so long as the termination payment is not made to secure another, more favorable contract.

Restructuring Debt While Deferring Taxable Income. Usually, when a company is discharged from an obligation to pay a debt, it must recognize cancellation of debt income. A new law allows a company to defer until 2014 COD income for debt "re-acquired" in 2009 or 2010. The deferred COD income is spread ratably over a five-year period. The deferral election applies to a variety of situations (including debt exchanges and some modifications) for debt instruments originally issued by corporations, LLCs, partnerships, and sole proprietorships.

These are just a few examples of how companies might find tax value from today's economic circumstances. Some losses might contribute to net operating losses the company can carry to other tax years. Nothing is one-size-fits-all, so evaluate these options carefully before claiming them on a tax return. ■

Gregory Gawlik and Jim Koenig are partners and Jon Stefanik is an associate in the tax group at Thompson Hine (Cleveland). Reach them at 216/566-5500, ext. 5908 (Gawlik), ext. 5503 (Koenig), or ext. 8876 (Stefanik).



Companies might find tax value from today's economic circumstances.