



JUNE 30, 2011

Self-Help for Taking Bad Debt Deduction Will Be Addressed in Final Debt-for-Equity Regs, IRS Official Says

by Amy S. Elliott

Summary by taxanalysts

Creditors seeking to use self-help measures to trigger a bad-debt deduction may find some guidance in the preamble to final section 108(e)(8) regulations that are expected to be released soon.

Full Text Published by taxanalysts

Creditors seeking to use self-help measures to trigger a bad-debt deduction may find some guidance in the preamble to final section 108(e)(8) regulations that are expected to be released soon, an IRS official said June 29.

The regs will likely take a section 721 approach, thereby generally preventing a party that exchanges a creditor position for a partnership interest in a debtor partnership from taking a bad-debt deduction, said Beverly Katz, special counsel, IRS Office of Associate Chief Counsel (Passthroughs and Special Industries).

"There might be something in the preamble that slightly mentions that issue, but there's not going to be a rule" in the regulations, Katz said. Curtis Wilson, IRS associate chief counsel (passthroughs and special industries), speaking on his own behalf, added that whether using self-help in that way is appropriate is a facts and circumstances inquiry. The two spoke at a Passthroughs and Real Estate Committee meeting of the District of Columbia Bar Taxation Section.

The proposed section 108(e)(8) regulations, issued in 2008, provide that when a party transfers its creditor position to the debtor partnership in exchange for an equity interest in the partnership, it realizes no gain or loss, and the partnership realizes cancellation of indebtedness income equal to the difference between the debt and the value of the interest received. (For prior coverage, see [Doc 2011-12754](#) or [2011 TNT 113-7](#). For REG-164370-05, see [Doc 2008-23074](#) or [2008 TNT 212-10](#).)

Steven R. Schneider, a director at Goulston & Storrs, noted that those most likely to be interested in self-help are mainly creditors whose debt is considered nonbusiness and who therefore can't just take a partial bad-debt write-off.

Series LLC Regs

After the finalization of proposed series limited liability company regulations, which generally treat each individual series as a separate juridical entity for federal tax purposes, owners of numerous individual series of a series LLC may be able to simplify their filing obligations by dropping all of the series interests into a single non-series LLC, according to the principal author of the September 2010 proposed regs.

"If the ownership interest percentages are identical, that would probably be OK," said Joy Spies, attorney-adviser, IRS Office of Associate Chief Counsel (Passthroughs and Special Industries). "I'm not so sure about the situation where there are slightly different ownership percentages." She added that the IRS is evaluating that scenario. (For prior coverage, see *Doc 2010-24236* or *2010 TNT 218-4*. For REG-119921-09, see *Doc 2010-19982* or *2010 TNT 177-12*.)

Schneider said that by dropping the series interests into a new LLC on top, the individual series become disregarded entities and only one partnership return would need to be filed. He said that another reason to take such a step might be to enable the owners "to have a better exit plan down the road without having to deal with unnecessary mixing bowl problems."

Check-the-Box Election Relief

The IRS is considering changing Form 8832, "Entity Classification Election," to prevent the kind of errors for which Rev. Proc. 2010-32 provided relief. Although it takes time to change the form, David Haglund, branch 1 chief, IRS Office of Associate Chief Counsel (Passthroughs and Special Industries), said that "we may look into that in the future."

Rev. Proc. 2010-32, issued September 7, generally enables a foreign eligible entity that miscalculated the number of its owners causing it to default to being taxed as a corporation rather than a passthrough to fix its error without seeking a private letter ruling. (For prior coverage, see *Doc 2010-19646* or *2010 TNT 173-4*. For Rev. Proc. 2010-32, 2010-36 IRB 320, see *Doc 2010-19454* or *2010 TNT 172-15*.)

Noncompensatory Partnership Options

Officials have said they plan to re-propose the noncompensatory partnership option rules before the IRS/Treasury business plan year ends on June 30. Wilson reiterated that although the government may miss its deadline, it is on the verge of re-proposing those regs, which were initially proposed in January 2003. He said officials are looking forward to getting them out and turning their attention to some other things. (For prior coverage, see *Doc 2011-11101* or *2011 TNT 100-4*. For the initial proposed regulations, REG-103580-02, see *Doc 2003-2099* or *2003 TNT 17-66*.)