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Discharge of Indebtedness: Insolvent Debtors and Debtors in Bankruptcy

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In the last issue, we examined the income tax consequences of transfers of property to creditors in discharge of debt.\(^4\) In this article, the focus is on the discharge of indebtedness for debtors in bankruptcy and those insolvent who are not in bankruptcy.\(^2\) In the next issue, we'll examine the discharge of debt for solvent farm debtors.

**Debtors in bankruptcy.** For debtors in bankruptcy, the most important rule is that the debtor has no income tax liability from discharge of indebtedness.\(^3\) That includes debtors in Chapter 12 bankruptcy as well as those in Chapters 7, 11 and 13.\(^4\) That doesn't mean, however, that the debtor doesn't suffer the effects of discharge of indebtedness. Indeed, the discharged debt leads to the reduction of the debtor's tax attributes and, possibly, the reduction of income tax basis for the debtor's property.\(^5\) The result is a postponement of income tax liability until the reduced tax attributes could have been used or the property with reduced income tax basis is sold.

For this purpose, it is not important whether the debtor is solvent or insolvent so long as the taxpayer is "...under the jurisdiction of the [bankruptcy] court."\(^6\) Thus, receivership, foreclosure or mere activation of UCC default proceedings do not qualify nor do forfeitures come within the definition.\(^7\)

A key rule to keep in mind is that no income is realized from the discharge of indebtedness to the extent that payment of the liability would have given rise to an income tax deduction.\(^8\) A farmer's operating expenses – for feed, fuel, fertilizer and repairs as well as interest - fall into this category if the obligation can be traced back to this type of expenditure.

Another important factor in handling the discharge of indebtedness in bankruptcy is when the debtor's tax attributes - net operating loss carryover, investment tax credit carryover, and capital loss carryover - pass to the bankruptcy estate at the beginning of the year of filing, usually as of January 1.\(^10\)

- In the event the debtor in bankruptcy elects two short years, the tax attributes do not pass to the bankruptcy estate until the beginning of the second tax year – as of the date of bankruptcy filing.\(^11\) That means the debtor may apply the tax attributes on the debtor's income tax return for the first short year.\(^12\)

The reduction in tax attributes is made after the determination of income tax for the taxable year of discharge.\(^13\)

**Regular order of adjustment.** The debtor has two choices in making adjustments from discharge of indebtedness – the regular approach and the special election to reduce basis first.

Here's the order of adjustment of tax attributes under the regular approach —

1. Any net operating loss for the tax year in which indebtedness is cancelled is first reduced\(^14\) followed by any net operating loss carryover to that year\(^15\) on a dollar-for-dollar basis.\(^16\)
2. Any general business credits or research credits for the current year are reduced next followed by any carryover of credits to that year\(^17\) on a basis of 33-1/3 cents of credits for each dollar of discharge of indebtedness.\(^18\)
3. Net capital losses for the year of debt cancellation and any capital loss carryover to that year are then reduced\(^19\) with the current year's loss applied first,\(^20\) again on a dollar-for-dollar basis.
4. The income tax basis of the debtor's property is reduced next.\(^21\) Several important points should be kept in mind in reducing the basis of property —
   - There is no reduction in basis of property treated as exempt to the debtor.\(^22\) This provision, permitting the protection of basis of exempt property, only applies to discharge of indebtedness in bankruptcy.
   - The reduction of basis applies to any property of the debtor, other than exempt property, whether depreciable or not, held at the beginning of the year after the year of discharge of indebtedness.\(^23\)

**Example:** Debt is discharged on March 30, 1990. Any adjustment in basis would be made as to property owned on January 1, 1991.

- The basis is reduced only down to the level of aggregate liabilities of the debtor.\(^24\)
- The reduction in basis is not treated as a disposition for purposes of recapture of investment tax credit (as normally occurs otherwise with a reduction in basis).\(^25\)
- Any reduction in basis is treated as a deduction allowed for depreciation\(^26\) with gain on later sale or exchange likely treated as recapture of depreciation and not capital gain.

- The sequence of basis reduction is prescribed in the regulations\(^27\) separately for corporate (four categories of property) and non-corporate (six categories of property) debtors with the adjustment for each category on a pro rata basis.

5. The last reduction is for foreign tax credits.\(^28\)

**Special election.** An election may be made to reduce the basis of depreciable property before reducing the other tax attributes mentioned above.\(^29\) If the election is made, the basis of property may be reduced to zero,\(^30\) thus enabling the taxpayer to preserve net operating loss, capital loss and credit carryovers. The election is made on the income tax return...
for the tax year of debt cancellation or discharge although the basis is reduced on the first day of the following tax year. Form 982 is used. If reasonable cause is shown, the election may be made on an amended return or claim for refund. The decision of whether to make the special election should be made only after careful consideration of the consequences under both the regular approach and the special election to reduce the basis of depreciable property first. The outcome is often substantially different with the two approaches.

In bankruptcy, after reducing the tax attributes and basis of property, the debtor is not required to report any remaining discharge of indebtedness as income. That is not required to report any remaining discharge of indebtedness. The election may be made on an Form 982 is used.

The amount of discharge of indebtedness that may be excluded from income is limited to the extent of the debtor's insolvency except for the solvent farm debtor rule that will be discussed in the next issue. The determination of insolvency is made immediately before the discharge of indebtedness. Insolvency is defined as an "excess of liabilities over the fair market value of assets." It appears that both tangible and intangible assets are included in the calculations and both recourse and nonrecourse liabilities are counted. However, it is not clear whether contingent liabilities should be included. Exempt property apparently is not included in the insolvency calculations. The separate assets of a debtor's spouse are not included in determining the extent of insolvency.

A point to remember: in discharging indebtedness, the taxpayer's net worth may rise by more than the amount of discharge of indebtedness for income tax reporting purposes. A write-off of accrued but unpaid interest for a cash basis taxpayer and a write-off of property taxes and other obligations that would have produced an income tax deduction if paid may nonetheless affect solvency of the taxpayer. Thus, the two sets of calculations – net worth and discharge of indebtedness – should be carried on contemporaneously.

### FOOTNOTES

1. See p. 69 supra.
4. See Ltr. Rul. 8928012, April 7, 1989 (Chapter 12 debtor was "in bankruptcy" for purposes of discharge of indebtedness).
5. See I.R.C. § 108(b).
7. Id.
10. I.R.C. § 1398(g).

### CASES, REGULATIONS AND STATUTES

#### ANIMALS

MISTREATMENT. The testimony of a deputy sheriff and a state veterinarian who had examined the horses was sufficient evidence to support a jury verdict convicting defendant of mistreatment of the horses because of failure to provide horses with adequate food and water. State v. Shaeffer, 450 N.W.2d 754 (N.D. 1990).

#### BANKING

NEGLOIGENCE. Farmers had borrowed from PCA for operating expenses for several years with the loans secured by farm equipment, land and crops "growing or to be grown." After negotiations for restructuring the loans, the PCA decided not to loan the farmers any more money and the money for the next year's crop was obtained elsewhere. The file filed an action for a money judgment and foreclosure on the collateral. The farmers countered that the PCA owed a fiduciary duty to them as shareholders of the PCA and that the PCA was liable in tort for bad faith in failing to exercise forebearance under the federal regulations. The court held that the fiduciary duty of a corporation extended to all shareholders as a group and not to individual shareholders. Because the farmers did not have a right to a private cause of action under the federal regulations, the farmers cannot sue the PCA in state court. Production Credit Ass'n v. Ista, 451 N.W.2d 118 (N.D. 1990).

#### BANKRUPTCY

GENERAL

ADMINISTRATIVE EXPENSES. The lessor of irrigation equipment was not allowed administrative expense priority for rent for the period between the debtor's filing for bankruptcy and the date the lease was deemed rejected where the debtor did not use the equipment during that period. In re Carmichael, 109 B.R. 849 (Bankr. N.D. Ill. 1990).

AUTOMATIC STAY. A debtor was not allowed to recover attorney fees