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WHEN DISCHARGE OF INDEBTEDNESS OCCURS IF THE DEBTOR IS NOT IN BANKRUPTCY

— by Neil E. Harl

As was noted in the March 30, 1990 issue of Agricultural Law Digest, whether discharge of indebtedness occurs for debtors in bankruptcy depends upon the chapter of the Bankruptcy Code. For Chapter 12 debtors, discharge of indebtedness takes place upon completion of payments under the plan.

For debtors not in bankruptcy, the rules for when discharge of indebtedness take place are different and the consequences are also quite different.

When discharge occurs

For debtors not in bankruptcy, discharge of indebtedness generally occurs when the creditor holding the debt takes a definitive act to discharge the debt. If no such act occurs, the debt is not discharged until the running of the statute of limitations under state law.

In a foreclosure action, discharge of indebtedness apparently occurs when all appeals of the action have been exhausted rather than in the year of the foreclosure sale. Gain or loss is recognized in the year of expiration of the right to redeem. For forfeitures of installment contracts or conveyances of assets to a creditor in lieu of foreclosure, gain or loss is realized at the date of the transfer.

As a general rule, discharge of indebtedness produces ordinary income. However, income from the discharge of indebtedness for an insolvent taxpayer is excluded from income. The amount of income from the discharge of indebtedness that can be excluded from income is limited to the extent of the debtor’s insolvency. Insolvency is defined as an “excess of liabilities over the fair market value of assets” but exempt property apparently is not included in the insolvency calculations.

The tax attributes of an insolvent debtor are reduced by the amount of income that is excluded from the taxpayer’s gross income because it is from discharge of indebtedness. The order of reduction of tax attributes — and the extent to which the tax attributes are reduced — are the same as in bankruptcy. An insolvent debtor has the same option as bankrupts to reduce the income tax basis of depreciable assets before other tax attributes are reduced. However, the rule specifying that the basis of exempt property is not to be reduced applies only to discharge of indebtedness occurring in bankruptcy.

Once a debtor has become or is solvent (not counting exempt property) the rules for solvent farm debtors may apply if the debtor was a person engaged in the trade or business of farming when the indebtedness was incurred. Fifty percent or more of the aggregate gross receipts for the last three years preceding the year of discharge came from the trade or business of farming. The discharged debt is “qualified farm indebtedness” and the debt is held by a “qualified person” as creditor. Under those rules, the tax attributes are first reduced and then the income tax basis of property used in a trade or business or held for the production of income is reduced with the basis reduced to zero.

Even for solvent farm debtors, discharge of indebtedness produces income once tax attributes have been reduced and the income tax basis of property subject to basis reduction has been reduced if the debtor is not in bankruptcy.

Whether a farm debtor is in bankruptcy or not affects not only the timing of the consequences of discharge of indebtedness; it can also affect the amount of discharge of indebtedness that must be reported into income. These factors should be taken into account in making the decision of whether to file for bankruptcy or to work out problems of excess debt informally.

FOOTNOTES

1 1 Agric. L. Dig. 77 (1990).
4 See Ryan v. Comm’r, T.C. Memo. 1988-12, aff’d, 89-1 U.S.T.C. ¶ 9282 (8th Cir. 1989) (accrual basis limited partners realized income from discharge of indebtedness in taxable year appeal of foreclosure action completed rather than year of foreclosure sale).
ADVERSE POSSESSION

HOSTILE USE. The disputed farm land was located on the plaintiff's side of a natural brush line separating the parties' properties. The plaintiffs used the disputed land for haying and sought declaration of title by adverse possession. The defendant argued that haying was insufficient hostile use to give rise to title by adverse possession. The court held that where the natural use of the land would be for haying, such use was sufficient hostile use to support title by adverse possession. Thompson v. Hayslip, 600 N.E.2d 756 (Ohio Ct. App. 1991).

BANKRUPTCY

AVOIDABLE TRANSFERS. Within the 90 days prior to the debtor's filing for bankruptcy, the debtor made several payments to a creditor who supplied the debtor with cheese products. Most of the cheese delivered remained unpaid for at the filing for bankruptcy. The trustee argued that the payments were preferential transfers to the extent the payments exceeded the amount still owed to the creditor, because the new value defense of Section 547(c)(4) was applicable only to the extent the goods remained unpaid for. The court found that the value of the cheese shipped after each payment exceeded the amount of each payment; therefore, the court held that under Section 547(c)(4), the transfers were not preferential because the creditor supplied new value for each payment. In re IRFM, Inc., 144 B.R. 886 (Bankr. C.D. Cal. 1992).

EXEMPTIONS.

AVOIDABLE TRANSFERS. The debtors, husband and wife, were the sole shareholders of a professional corporation operating the husband's medical practice. The corporation had established an ERISA qualified defined benefit plan and the debtors claimed their interests in the plan as exempt. The trustee sought to avoid contributions to the plan as fraudulent conveyances but the court held that the trustee failed to prove that any pre-bankruptcy contributions to the plan were made with intent to hinder, delay or defraud creditors. In re Shailam, 144 B.R. 626 (Bankr. N.D. N.Y. 1992).


CHAPTER 11

PLAN MODIFICATION. After the debtors had completed most of the payments to FmHA on its secured and unsecured claims, the debtors sought to make one final payment for the claims based upon the current value of the remainder of the claim. The debtors argued that the final payment could be discounted to account for the lack of interest on the unsecured claim payments and for the payment, under the plan, of the claim over four more years. The court held that the discounted prepayment of the claims was not allowed because the plan did not provide for any prepayment. In re Hunter, 144 B.R. 871 (Bankr. D. S.D. 1992).

FEDERAL TAXATION

AUTOMATIC STAY. During the period of the debtors' Chapter 13 plan, the IRS filed a Notice of Intent to Levy against the debtors in violation of the automatic stay. The court held that under Section 106, the IRS had waived its immunity against sanction for violation of the automatic stay because the IRS had filed a claim in the case. The debtor was awarded attorney's fees and other costs or damages incurred because of the violation. In re Tyson, 145 B.R. 91 (Bankr. M.D. Fla. 1992).

The debtor's case was reopened for the limited purpose of enforcing a stipulation entered into between the debtor and one creditor. The parties entered into another court approved stipulation for payment; however, before the payments were made, the IRS levied against the debtor's property, making the payment impossible. The debtor argued that the levy violated the automatic stay invoked by the reopening of the case. The court held that the reopening was limited to the matter involved and did not reinstate the automatic stay. In re Gruetzmacher, 145 B.R. 270 (Bankr. W.D. Wis. 1991).

CLAIMS. Prior to the debtor's filing for Chapter 13 bankruptcy, the IRS perfected a tax lien against the debtor's...