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WHEN DISCHARGE OF INDEBTEDNESS OCCURS IN BANKRUPTCY

— by Neil E. Harl

The farm debt crisis of the 1980’s left numerous legacies, not the least of which is the continuing discharge of indebtedness from formal and informal resolutions of excessive debt. The various rules on when discharge of indebtedness occurs have created surprising and painful results for some taxpayers.

When discharge occurs in bankruptcy

The question of when discharge of indebtedness occurs in bankruptcy depends upon which chapter of bankruptcy is involved.  

- In Chapter 7 bankruptcy, if no objections are sustained, discharge normally takes place 60 days after the meeting of creditors at which the debtor appears and is examined under oath. As a consequence, discharge ordinarily occurs soon after bankruptcy filing.  

- Under Chapter 11 bankruptcy, discharge of indebtedness occurs upon confirmation of a plan of reorganization as to debts arising before confirmation, with some exceptions. Thus, discharge of indebtedness ordinarily occurs soon after bankruptcy filing.  

- By contrast, in Chapter 12 bankruptcy discharge of indebtedness occurs “as soon as practicable” after completion of payments under the plan. That means discharge ordinarily takes place more than three years after bankruptcy filing and it could be more than five years after filing, depending upon the length of the Chapter 12 reorganization plan.  

- In a Chapter 13 bankruptcy, discharge likewise occurs upon completion of payments under the plan. Again, that is usually more than three years after bankruptcy filing.

Consequences of discharge in bankruptcy

Indebtedness cancelled as a result of bankruptcy is not included in the debtor's income. IRS has ruled, as expected, that Chapter 12 debtors are “in bankruptcy” for purposes of discharge of indebtedness. Thus, even though no new tax entity is created on Chapter 12 filing for individuals, those filing under Chapter 12 bankruptcy are eligible for the so-called “bankruptcy” exception to the general rule that discharge of indebtedness produces ordinary income. The result is no immediate tax liability from discharge of indebtedness; rather, the income tax consequences to the debtor are largely postponed until the debtor's property is sold (on which basis was reduced) or the reduced tax attributes (credits and losses) could have been used. Excess discharge of indebtedness need not be reported into income. Note that discharge of indebtedness for Chapter 12 debtors does not come under the rule for solvent farm debtors (which requires that discharge of indebtedness be reported into income for solvent debtors after reduction of tax attributes and basis of property), even though the debtor is solvent at the time of discharge of indebtedness as is required for the solvent farm debtor rule to apply. Thus, the fact that the Chapter 12 debtor is "in bankruptcy" continues to clothe the debtor from the full measure of consequences of discharge of indebtedness.

That is because, for debtors in bankruptcy, once tax attributes have been reduced and the basis of the debtor's property has been reduced down to the indebtedness, IRS has held, the election to reduce the basis of property to the amount of indebtedness (which requires that discharge of indebtedness be reported into income for solvent debtors after reduction of tax attributes and basis of property) generally sidesteps much of the adverse consequences of discharge of indebtedness in bankruptcy. For those Chapter 12 filers who are able to use up operating loss, capital loss and credit carryovers by the time of discharge of indebtedness and who have indebtedness equal to or greater than the basis of assets subject to basis reduction, there may be no negative consequences of discharge of indebtedness.

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8 Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.

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11 This factor can be of immense importance to Chapter 12 bankruptcy filers who often are solvent by the time indebtedness is discharged upon completion of payments under the plan. Chapter 12 debtors can, therefore, generally sidestep much of the adverse consequences of discharge of indebtedness in bankruptcy. For those Chapter 12 filers who are able to use up operating loss, capital loss and credit carryovers by the time of discharge of indebtedness and who have indebtedness equal to or greater than the basis of assets subject to basis reduction, there may be no negative consequences of discharge of indebtedness.
FOOTNOTES
3 Id., § 39.03(3).
4 Bkrcy. Rule 4004(a), (c).
9 Ltr. Rul. 8928012, April 7, 1989.
10 I.R.C. § 1398(a) (new entity concept applicable only to Chapter 7 and 11 filers).
11 I.R.C. § 61(a)(12). See, e.g., Vukasovich, Inc. v. Commr, 790 F.2d 1409 (9th Cir. 1986), app’d in part and rev’d in part, T.C. Memo. 1984-611 (cancellation of indebtedness for less than amount owed resulted in ordinary income to debtor).
12 See Harl, Discharge of Indebtedness, Insolvent Debtors and Debtors in Bankruptcy, 1 Agric. L. Dig. 77 (1990). See also 4 Harl, Agricultural Law § 39.03 (1992).
13 I.R.C. § 108(g).
14 I.R.C. § 108(g)(3)(D).
15 I.R.C. § 1017(b)(2).
16 I.R.C. §§ 108(b)(5); 1017(b)(2).
20 See I.R.C. § 1017(b)(2).

CASES, REGULATIONS AND STATUTES
by Robert P. Achenbach, Jr.

BANKRUPTCY

EXEMPTIONS.
AVOIDABLE LIENS. A hospital perfected statutory liens against the proceeds of an automobile accident insurance policy received by the debtor resulting from an automobile accident. The debtor claimed an exemption for the insurance proceeds and avoidance of the hospital lien as impairing the exemption. The court held that because the hospital lien arose purely by act of statute, the lien could not be avoided and had priority over the debtor’s exemption claim. In re Pohrman, 146 B.R. 570 (Bankr. D. Or. 1992).

The debtors sought to avoid a judgment lien against their homestead which was claimed as an exemption. The judgment creditor argued that because the debtor had waived the homestead exemption as to the judgment lien when the lien attached, the debtor was precluded from claiming the homestead exemption as to the judgment lien. The court held that under North Carolina case law, a waiver applied only to the execution of the judgment lien and that a bankruptcy filing was treated as a separate execution for which a separate waiver would have to be filed. Thus, the judgment lien could be avoided because the debtors had not waived the homestead exemption in the bankruptcy case. In re Pinner, 146 B.R. 659 (Bankr. E.D. N.C. 1992).

IRA. The debtors’ interests in custodial IRA’s were held to be exempt under Ill. Rev. Stat. ch 110, ¶ 12-1006 where the IRA’s were established with a good faith intent to qualify under the Internal Revenue Code. The court also held that the IRA’s did not need to qualify as spendthrift trusts in order to be exempt. In re Templeton, 146 B.R. 757 (Bankr. N.D. Ill. 1992).

CHAPTER 13

DISPOSABLE INCOME. The debtors’ Chapter 13 plan provided for a 41 percent payment of unsecured creditors’ claims and provided for personal expenses to include $614 per month for tuition and rent for a child in college. A creditor argued that the tuition and rent should be included in disposable income as excessive and unnecessary personal expenses. The court held that because the child was a senior and was attending a low cost state college, the expenses were necessary and not unreasonable, especially where the unsecured creditors were receiving 41 percent of their claims and would receive nothing in a Chapter 7 case. In re Riegodedios, 146 B.R. 691 (Bankr. E.D. Va. 1992).

FEDERAL TAXATION

CLAIMS. An IRS late-filed claim amendment for over $2 million in unpaid taxes was denied because the amendment was significantly different from the original claim for $11,000. The court held that the existence of an ongoing audit of the tax returns for the tax years subject to the claim did not excuse the IRS for failure to seek extension of time to file claims. In re Stavriotis, 977 F.2d 1202 (7th Cir. 1992), aff’d, 129 B.R. 527 (N.D. Ill. 1991), aff’d, 103 B.R. 1005 (Bankr. N.D. Ill. 1989).

EXCISE TAXES. The debtor filed for bankruptcy in July 1986 and the IRS filed claims for 1984, 1985 and 1986 for the excise tax on accumulated funding deficiencies in the debtor’s ERISA plans. The debtor had obtained a waiver for 1984 and was current on payment terms up to the filing for bankruptcy but stopped making payments after the filing. No waiver was obtained for 1985 but the bankruptcy filing occurred before the latest date for which the deficiency could have been paid without penalty. The 1986 liability occurred post-petition. The court held that the excise tax for all three years would not be allowed because the liability arose post-petition and would violate the automatic stay. For 1984, the waiver acted as a credit to relieve the deficiency until payments were not made under the waiver agreement. The court held that a retroactive provision was invalid as contrary to statute. In re Chateaugay Corp., 146 B.R. 626 (S.D. N.Y. 1992).

JURISDICTION. Under the debtor’s plan, an amount was to be paid to a third party who filed a claim in the case. The plaintiff had a judgment lien against the property of the