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Student loan chargeoff  
Dischargeability of Debt

Johnson v. U.S. Dept. of Human Svcs.                      00-6233-fra13  
In re Craig Johnson                      695-63282-fra13

3/27/01                      Alley                      Unpublished

Plaintiff/Debtor filed bankruptcy under Chapter 13 in 1995 and received a discharge of debts in July, 2000. At the petition date, the Debtor was indebted to the Defendant for one or more student loans. After Debtor's discharge was granted, he filed an adversary proceeding alleging that the student loan debt should be discharged under the undue hardship provisions of the Bankruptcy Code.

In 1999, prior to entry of the discharge, the Defendant wrote off the loan - the effect being to permanently end all collection efforts. In the adversary proceeding, the Defendant asserted that, because the effect of the chargeoff is irreversible, there was no debt to discharge and no controversy for the bankruptcy court to determine. The issue in the case is whether the Government can, by unilaterally abandoning a claim, effectively prevent the discharge of the claim through bankruptcy. The practical effect on the Debtor between discharge and writeoff concerns the taxability of the forgiven debt.

The court determined that the effect of the chargeoff, pursuant to federal regulation, is to erase the debt altogether. There is nothing in the Bankruptcy Code to constrain the Government from exercising its discretion to charge off debts owed to it. Consequently, there was no student loan debt to discharge when the order of discharge was entered. Defendant's motion to dismiss was granted.

E01-3(6)

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UNITED STATES BANKRUPTCY COURT  
FOR THE DISTRICT OF OREGON

In Re:	)	Bankruptcy Case No.
	)	
CRAIG JOHNSON,	)	Case No. 695-63282-fra13
	)	
_____ Debtor.	)	
	)	
CRAIG JOHNSON,	)	Adv. Pro. No. 00-6233-fra
	)	
Plaintiff,	)	
vs.	)	MEMORANDUM OPINION
	)	
UNITED STATES DEPARTMENT OF	)	
HEALTH AND HUMAN SERVICES,	)	
	)	
_____ Defendant.	)	

Defendant urges the court to dismiss this adversary proceeding on the grounds that there is no controversy. The court finds that the motion is well taken, and that it should be granted.

I. BACKGROUND

Plaintiff is the Debtor in the underlying chapter 13 case, filed in 1995. His plan of reorganization was confirmed and completed, and a discharge order was entered pursuant to 11 U.S.C. § 1328 on July 26, 2000.

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1           At the time he filed his petition for relief Debtor was indebted  
2 to Defendant on account of one or more student loans. Such loans are  
3 excepted from discharge unless the debtor can show that excepting the  
4 debtor from discharge would impose an undue hardship on the debtor or  
5 his dependents. 11 U.S.C. § 523(a)(8). Debtor's complaint filed on  
6 August 15, 2000, alleges that "The student loan payments required, at  
7 this point, creates [sic] an undue hardship on the Debtor in that his  
8 [chiropractic] practice is not generating sufficient funds to make even  
9 nominal payments on the student loans".<sup>1</sup>

10           In 1999, prior to entry of the discharge, the United States  
11 charged off the loan, writing off just over \$100,000. The effect of  
12 the decision is to end, permanently, all collection efforts. 31 CFR  
13 § 903.5(a).<sup>2</sup> The Government now asserts that, because the effect of  
14 the charge off is irreversible, there is no longer any debt to  
15 discharge. If this is correct, there is no controversy for this court  
16 to determine.<sup>3</sup>

17 \_\_\_\_\_  
18           <sup>1</sup>In a second claim the Debtor claims that the loans are over 10  
19 years old, and that it would be "unconscionable for Debtor to be  
20 responsible to repay" the loans. The standard for discharge of  
21 student loans is the "undue hardship" principle set out in  
11 U.S.C. § 523(a)(8), and there is no separate equitable discharge  
as the pleading suggests. The age of the loans is immaterial under  
the present statute.

22           <sup>2</sup>The effective date of this section was December 22, 2000.  
23 Presumably it applies to collection of claims written off prior to  
the effective date.

24           <sup>3</sup>Procedurally, the Government has moved to dismiss the case  
25 pursuant to Fed. R. Bankr. P. 7012(b)(6), which incorporates Fed. R.  
26 Civ. P. 12(b)(6) (allowing dismissal for failure to state a claim).  
The motion was supported by the declaration of an employee of the  
(continued...)

1 Plaintiff responds that the Government's "charge off" is no more  
2 than an accounting device, and cannot be used to deny Debtor his right  
3 to a judgment discharging the claim under the Bankruptcy Code, and that  
4 writing off the loan was "inappropriate" as long as the bankruptcy case  
5 remained open.

## 6 II. ANALYSIS

7 The paramount issue in this case is whether the Government  
8 can, by unilaterally abandoning a claim, effectively prevent the  
9 discharge of the claim through bankruptcy. The distinction between  
10 discharge and write off is by no means academic. Generally, when a  
11 debt is forgiven or charged off the value of the debt is reportable  
12 as ordinary income to the debtor. 26 U.S.C. § 61(a). Gross income  
13 does not include income attributable to discharged debts if the  
14 discharge occurs in a title 11 case, or if it occurs while the  
15 taxpayer is insolvent. 26 U.S.C. § 108(a)(1). Regulations  
16 governing the charge off of debts owed to federal agencies require  
17 that the charge off be reported to the IRS.

18 According to the declaration submitted with the Government's  
19 motion, the student loan debt was found to be uncollectible in 1999,  
20 after considerable effort to collect. As a result of this  
21 determination the debt was written off, and a report to that effect  
22 filed with the IRS on form 1099-C.

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25 <sup>3</sup>(...continued)  
26 Department of Education.

1           The effect of the charge off is set out in the Code of  
2 Federal Regulations, at 31 CFR § 903.5(a):

3           (a) before discharging a delinquent debt (also  
4 referred to as a close out of the debt), agencies  
5 shall take all appropriate steps to collect the debt  
6 in accordance with 31 U.S.C. 3711(g), including, as  
7 applicable, administrative offset, tax refund offset,  
8 Federal salary offset, referral to Treasury, Treasury-  
9 designated debt collection centers or private  
10 collection contractors, credit bureau reporting, wage  
11 garnishment, litigation, and foreclosure. Discharge  
12 of indebtedness is distinct from termination or  
13 suspension of collection activity under part 903 of  
14 this title and is governed by the Internal Revenue  
Code. When collection action on a debt is suspended  
or terminated, the debt remains delinquent and further  
collection action may be pursued at a later date in  
accordance with the standards set forth in this  
chapter. *When an agency discharges a debt in full or  
in part, further collection action is prohibited.*  
Therefore, agencies should make the determination that  
collection action is no longer warranted before  
discharging a debt. Before discharging a debt,  
agencies must terminate debt collection action.  
[Emphasis added].

15           The Bankruptcy Code defines "debt" as "liability on a claim";  
16 a "claim" is defined as "a right to payment" 11 U.S.C.  
17 § 101(5), (12). Once the Government has charged off the debt as  
18 uncollectible, and reported that a taxable event has occurred, the  
19 obligor is entitled to rely on the regulation's prohibition of  
20 further enforcement efforts. For all intents and purposes the debt  
21 is permanently extinguished. This is distinguished by the  
22 regulations from suspension of collection activities, and is more  
23 than a mere bookkeeping entry -- the claim has not been held in  
24 abeyance, but erased altogether. Any resulting tax liability is  
25 not, as Debtor suggests, a remnant of the student loan claim. It is  
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1 an independently arising liability based on a pecuniary benefit  
2 received by virtue of the extinguished liability. If the charged  
3 off claim were held by an entity other than the Government, the tax  
4 impact would be the same. Moreover, Debtor points to no provision  
5 which earmarks any tax payable by the Debtor on account of the  
6 charge of to the agency that authorized it.

7 Debtor claims that the charge off was "inappropriate", but  
8 does not elaborate. It is not clear what standard or rule has been  
9 violated, and the Court will not search the law or the record to  
10 find flaws in the Government's position. It may be that the  
11 Government's action impairs a debtor's ability to make a fresh  
12 start. However, there is nothing in the Bankruptcy Code which  
13 constrains the Government's exercise of its discretion to charge off  
14 debts owed to it, or to render permanent the effect of that  
15 decision. Nor can it be said that the Government's action is  
16 entirely inequitable: while its action may give rise to tax  
17 liability the Debtor cannot discharge, it has given up its right to  
18 contest discharge of any of the student loan liability. Given the  
19 heavy burden on a debtor to discharge such claims, and the fact that  
20 any tax liability is only a percentage of the original claim, the  
21 trade off is not insubstantial.

22 It may be that claims most likely to be charged off under 31  
23 CFR § 903.5(a) are also the most likely to be discharged as  
24 constituting an undue hardship under 11 U.S.C. § 523(a)(8).  
25 However, the Debtor will not incur any tax liability if he was  
26 insolvent at the time the Government charged off the debt. 26

1 U.S.C. §108(a)(1)(B).<sup>4</sup> In any event, any conflict between the fresh  
2 start policy inherent in the Bankruptcy Code, and the Government's  
3 duty to protect the interest of its taxpayers, is a policy issue  
4 which must be addressed by Congress. The Court cannot strike the  
5 balance by declaring the Government's approach to be  
6 "inappropriate".

7 Debtor's complaint seeks a judgement to the effect that his  
8 student loan debt was discharged by the discharge order of July 26,  
9 2000. At that time there was no longer any claim to discharge. It  
10 follows that there is nothing for the Court to determine, and that  
11 the complaint must be dismissed.

12 The foregoing opinion constitutes the Court's findings of  
13 fact and conclusions of law. An order consistent with this opinion  
14 has been entered.

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18 FRANK R. ALLEY, III  
19 United States Bankruptcy Judge  
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23 <sup>4</sup> 26 U.S.C. §108(d)(3) provides:  
24 For the purposes of this section, the term "insolvent" means the  
25 excess of liabilities over the fair market value of assets. With  
26 respect to any discharge, whether or not the taxpayer is insolvent,  
and the amount by which the taxpayer is insolvent, shall be  
determined on the basis of the taxpayers assets and liabilities  
immediately before the discharge"