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THE GROSS INCOME TEST FOR CHAPTER 12
BANKRUPTCY ELIGIBILITY

— by Neil E. Harl*

Chapter 12, added to the Bankruptcy Code in 1986¹ may be initiated only voluntarily and is available only to a "family farmer" whose debts do not exceed $1,500,000.² At least 80 percent of the debts (other than debts on the principal residence unless the debt arose out of a farming operation) must have arisen out of a farming operation owned or operated by the debtor or debtor and spouse.³ Moreover, an individual debtor or debtor and spouse must have earned more than 50 percent of their gross income from farming for the preceding taxable year.⁴ Closely held corporations and partnerships may also be eligible debtors if similar tests are met except that no gross income test applies to those entities.⁵

The gross income test imposed on individual debtors has provoked a great deal of litigation, particularly over the question of what is "gross income from farming."⁶

Meaning of "gross income." The bankruptcy court has relied upon the definition of gross income used for federal income tax purposes.⁷ As the statute mandates, the gross income figure is from the taxable year preceding the year of filing⁸ even though the debtor filed bankruptcy on the last day of the taxable year.⁹

The more difficult issue is whether gross income is "from farming."

Non-farm enterprises. The line between gross income from farming and gross income from non-farm enterprises is an important issue. In a 1990 Colorado case, for example, income from a residential lawn spraying business and crop spraying was not income from farming for Chapter 12 bankruptcy purposes.¹⁰ And in a 1987 Illinois case, a debtor was not eligible for Chapter 12 bankruptcy where more than 50 percent of gross income came from horse training and showing.¹¹ In a recent case, the debtors operated a traditional farm and had income from a sawmill in which they cut lumber from trees harvested from their land.¹² The court held that the logging and sawmill operations were not farming and the debtors were not eligible for Chapter 12 because the income from the sawmill and lumbering operations exceeded the income from the farm.

Another aspect of the question, particularly with respect to non-farm income, is how to calculate gross income. In a

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* 1988 Illinois case, the gross income from a non-farm enterprise was defined as sales proceeds less the cost of goods sold; with that calculation, farm income exceeded nonfarm income and the debtors were eligible for Chapter 12 bankruptcy.¹³ Similarly, in a 1989 Oklahoma case, the nonfarm income from a bar business was calculated on gross sales less the cost of goods sold.¹⁴ A 1988 Colorado case involved a net loss from a nonfarm business as well as other nonfarm income.¹⁵ The loss was not subtracted from the nonfarm income and the debtor was not eligible for Chapter 12 because nonfarm income exceeded farm income.¹⁶

Nonfarm activity related to farm operation. An activity which, if standing alone, would be nonfarm income may be considered as farm income if related to a farming operation. Thus, in a 1987 Wisconsin case, income from horse riding stables was considered as farm income where the horses were raised by the debtor. The feed for horses and cows from an accompanying dairy operation was raised by the debtor and the horse and dairy operations were combined.¹⁷ In a similar manner, a debtor's income from hauling cattle for third parties was considered to be from farming because it was related to the debtor's own cattle business.¹⁸ By contrast, the income from rental of houses on farm land was not income from farming.¹⁹ The raising and harvesting of timber on a sustained yield basis as part of a crop and livestock operation have been held to be a farming operation.²⁰

Government programs. In general, income from government farm programs is considered to be gross income from farming for purposes of Chapter 12 eligibility. Thus, income from Conservation Reserve Program payments has been considered to be an integral part of farming and, therefore, includible in gross income from farming.²¹ Income from placing grain under Commodity Credit Corporation (CCC) loan was considered gross income from farming where the debtors claimed the CCC loan as income²² for federal income tax purposes.²³ In a 1990 case, government cost sharing payments were included in gross income from farming but directors' fees from farm corporations were not included in gross income from farming.²⁴ ASCS payments have been considered to be gross income from farming.²⁵

Sale of farmland and equipment. Proceeds from the sale of farm equipment were considered to be gross income from farming in a 1987 Ohio case.²⁶ Yet proceeds
from the sale of farmland in a 1988 California case were not includable as gross income from farming. A similar result was reached in a 1987 Arkansas case holding that a debtor was not eligible for Chapter 12 bankruptcy where more than 50 percent of the debtor's gross income came from the sale of farm and other land.

Income from corporation. In the cases decided to date, income received from a farm corporation has been considered to be gross income from farming for Chapter 12 eligibility purposes. Thus, in a 1987 Iowa case, wages received from working for a farm corporation were included in gross income from farming where the corporation was owned by the debtor's children and the debtors supplied the machinery. Even more broadly, in another 1987 Iowa case, debtors who were officers, shareholders and employees of a farm corporation were eligible for Chapter 12 bankruptcy if the debtors could show they received any income from corporate farm operations.

Custom farming. Income from custom farming, even if done for a farm corporation owned by the debtor, was held in one case not to be gross income from farming.

FOOTNOTES
4 Id.
11 In re McKirllips, 72 B.R. 565 (Bankr. N.D. Ill. 1987).
16 Id.
17 In re Wolline, 74 B.R. 208 (Bankr. E.D. Wis. 1987).
19 In re Maschhoff, 89 B.R. 768 (Bankr. S.D. Ill. 1988).
22 See I.R.C. § 77(a).
26 Id.
31 In re Hampton, 100 B.R. 535 (Bankr. E.D. Or. 1987).
39 In re Easton, 118 B.R. 676 (Bankr. N.D. Iowa 1990), on rem. from 883 F. 2d 630 (8th Cir. 1990), vac'g and rem'g 104 B.R. 111 (N.D. Iowa 1989), aff'g 79 B.R. 836 (Bankr. N.D. Iowa 1987).
41 In re Fogle, 87 B.R. 493 (Bankr. N.D. Ohio 1988).
45 In re Easton, 118 B.R. 676 (Bankr. N.D. Iowa 1990), on rem. from 883 F. 2d 630 (8th Cir. 1990), vac'g and rem'g 104 B.R. 111 (N.D. Iowa 1989), aff'g 79 B.R. 836 (Bankr. N.D. Iowa 1987).