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Bankruptcy Court Interpretation of Chapter 12 Tax Rules

-by Neil E. Harl* and Joseph A. Peiffer**

The first Bankruptcy Court interpretation[1] of the provisions in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005[2] pertaining to the income tax treatment of asset dispositions in Chapter 12 bankruptcy cases[3] has been published. The first case, involving a hog farmer from Northern Iowa who had encountered disease problems in the swine herd and a series of accidents (following a period of low hog prices), tested the income tax rules enacted in 2005 for Chapter 12 filers. Although the decision was favorable to the taxpayers on some issues, the opinion did not go as far as the taxpayer had hoped. Counsel for the taxpayer indicates that an appeal is likely and legislative clarification of the key issues has not been ruled out.

Background on Chapter 12 tax treatment

Six years before enactment of Chapter 12 bankruptcy in 1986,[4] Congress enacted the Bankruptcy Tax Act of 1980,[5] which expanded and clarified the income tax treatment of taxpayers in bankruptcy. Among other provisions, the 1980 legislation specified that individual Chapter 7 and 11 filers (but not partnerships or corporations)[6] were eligible for separate entity status.[7] With separate entity status, the debtor's assets as well as tax attributes[8] pass into the bankruptcy estate which becomes liable for payment of income taxes triggered in bankruptcy.[9] Thus, the separate entity in bankruptcy is an integral part of the "fresh start,"[10] which is a prominent feature of U.S. bankruptcy law. Indeed, the "fresh start" of bankruptcy has been described as the most extensive 'since the seven-year release described in the Old Testament.'[11] The separate entity insulates debtors from tax liability arising from ordinary income and capital gains as well as most other income tax consequences during the period the separate entity is functioning.

For reasons that have never been clear, Congress in enacting Chapter 12 bankruptcy in 1986[12] did not extend the separate entity concept to Chapter 12 debtors.[13] Thus, from the beginning, income tax liability incurred in a Chapter 12 bankruptcy has been the responsibility of the debtor.[14]

The 2005 enactment

As part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005,[15] the Congress attempted to remedy the omission in 1986.[16] The approach taken was to provide

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Happy Holidays to You and Yours!

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that a Chapter 12 debtor could treat liabilities arising out of "claims owed to a governmental unit," such as income tax on the gain or recapture income, as a result of "sale, transfer, exchange, or other disposition of any farm asset used in the debtor's farming operation" as an unsecured claim that is not entitled to priority under Section 507(a) of the Bankruptcy Code, provided the debtor receives a discharge.[17] By declaring such "claims owed to a governmental unit" to be unsecured claims, rather than priority claims, the amounts would be eligible for discharge.

Bankruptcy Court interpretation

In the first judicial interpretation of the 2005 language, *In re Knudsen*,[18] the court first held that the language "farm asset used in the debtor's operation" limited the scope of the provision to assets used in the trade or business which are eligible for capital gain treatment under I.R.C. § 1231 (and presumably capital assets under I.R.C. § 1221) and was not sufficiently broad to include assets held for sale such as slaughter hogs or grain.[19] The debtor had argued that, as a relief provision, the favorable treatment should be extended to taxes arising from the sale or other disposition of any farm asset, when the disposition was made in furtherance of restructuring the debtor's operation.[20] The court's approach may lead to creative restructuring of transactions to convert assets ordinarily producing ordinary income into capital gain transactions.[21] Examples include the sale of land with an unharvested crop so that the sale of the growing crop is considered a sale of an asset eligible for capital gain treatment[22] and failure to identify a hedge as a hedge which results in capital gain and capital loss treatment rather than ordinary gain and ordinary loss treatment.[23]

The Bankruptcy Court also held that, in allocating tax claims between those attributable to the sale of farm assets eligible for the special treatment allowing possible discharge and those taxes entitled to priority status, which are not eligible for possible discharge and must be paid in full in order to get the Chapter 12 plan confirmed, the method used should be to pro rate the taxes.[24] The debtor had argued for a marginal approach which, because of the graduated tax rates, would be more favorable to the debtor.

The Bankruptcy Court agreed with the debtor that the statutory language changes the character of the taxes from priority status to unsecured status such that, upon discharge, the unpaid portion of the tax is discharged along with any interest or penalties.[25] The court also agreed that the relief provision in the 2005 enactment applies to post-petition taxes and, while a separate estate is not created, the taxes on the income of the debtors can be treated as administrative expenses.[26] The post-petition taxes on the sale of farm assets eligible for the special treatment are treated as an unsecured claim, not a priority claim.[27] Thus, those post-petition taxes are dischargeable without payment in full provided that the amounts are provided for in the plan and the debtors receive a Chapter 12 discharge.[28]

The court indicated that it is appropriate to use a Chapter 12 liquidation analysis (which adds the portion of the tax treated as an unsecured claim to the traditional unsecured claims in determining whether the best-interest-of-creditors test is met) rather than the Chapter 7 liquidation analysis (which requires that the tax claim be treated as a priority claim to be paid in full).[29] Using the Chapter 12 liquidation analysis allows more plans to be confirmed than would be the case with the Chapter 7 approach. However, unsecured creditors may push for liquidation of low basis assets with some equity, which are not essential to the farming operation with the income tax treated as an unsecured claim under Section 1222(a)(2)(A), sharing in the distribution of the net proceeds to unsecured creditors rather than the liquidated asset being treated as though it would be abandoned by the trustee in a Chapter 7 and the debtor maintaining ownership after plan confirmation.

IRS offer to provide assistance on income tax effects of proposed Chapter 12 plans

On November 27, 2006, the Internal Revenue Service announced procedures to be followed to request determinations of the income tax effects of proposed Chapter 12 plans.[30] Presumably, the IRS analysis will reflect the guidance from *In re Knudsen*[31] rather than the IRS positions announced in connection with the *Knudsen* litigation.

Footnotes

[1] *In re* Knudsen, No. 05-03136M, 2006 Bankr. LEXIS 86686 (Bankr. N.D. Iowa 2006).

[2] Pub. L. No. 109-8, § 1003, 119 Stat. 23 (2005).

[3] See generally 5 Harl, *Agricultural Law* § 39.04[2][b] (2006); Harl, *Agricultural Law Manual* § 13.03[7][e] (2006).

[4] Pub. L. No. 99-554, 100 Stat. 3105 (1986), adding 11 U.S.C. § 1201 *et seq*.

[5] Pub. L. No. 96-589, 94 Stat. 3389 (1980).

[6] I.R.C. § 1399.

[7] I.R.C. §§ 1398(a), (f), 1399.

[8] I.R.C. § 1398(f), (g).

[9] See 5 Harl, note 3 *supra* for a detailed discussion of the functioning of the bankruptcy estate as a new tax entity.

[10] 11 U.S.C. § 727(a)(1). See Brown v. Felsen, 442 U.S. 127 (1979).

[11] *In re* Bailey, 53 B.R. 732, 736 (Bankr. W.D. Ky. 1985).

[12] See note 4 *supra*.

[13] See 5 Harl, note 3 *supra*.

[14] *In re* Lindsey, 92-2 U.S. Tax Cas. (CCH) ¶ 50,400 (Bankr. W.D. Okla. 1992) (trustee acted in capacity of standing trustee, not as trustee of liquidating trust).

[15] See note 2 *supra*.

[16] See 11 U.S.C. § 1222(a)(2).

[17] BAPCPA of 2005, § 1003, note 2 *supra*, adding 11 U.S.C. § 1222(a)(2).

[18] No. 05-03136M, 2006 Bankr. LEXIS 86686 (Bankr. N.D. Iowa 2006).

[19] *Id*.

[20] *Id*.

[21] See I.R.C. §§ 1231(b), 1221.

[22] I.R.C. § 1231(b)(4).

[23] Treas. Reg. § 1.1221-2(f)(1), (2).

[24] *Id*.

[25] *Id*.

[26] See 11 U.S.C. § 501(b)(1)(B).

[27] *Id*.

[28] *Id*.

[29] *Id*.

[30] Rev. Proc. 2006-52, 2006-2 C.B. 995.

[31] See note 1 *supra*.