5-25-2012

The U.S. Supreme Court Settles (for Now) One of the Chapter 12 Bankruptcy Tax Issues

Neil E. Harl
Iowa State University

Joseph A. Peiffer
Iowa State University

Follow this and additional works at: http://lib.dr.iastate.edu/aglawdigest

Part of the Agricultural and Resource Economics Commons, Agricultural Economics Commons, Agriculture Law Commons, and the Public Economics Commons

Recommended Citation

Available at: http://lib.dr.iastate.edu/aglawdigest/vol23/iss11/1

This Article is brought to you for free and open access by the Journals at Iowa State University Digital Repository. It has been accepted for inclusion in Agricultural Law Digest by an authorized editor of Iowa State University Digital Repository. For more information, please contact digirep@iastate.edu.
Agricultural Law Digest

Volume 23, No. 11  May 25, 2012  ISSN 1051-2780

The U.S. Supreme Court Sets (for Now) One of the Chapter 12 Bankruptcy Tax Issues

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

On May 14, 2012, just over seven years after enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (popularly referred to as BAPCPA), the United States Supreme Court resolved the conflict in the Circuit Courts of Appeal over the taxation of income and capital gains in a Chapter 12 Bankruptcy case under BAPCPA. The holding of the high court denies Chapter 12 debtors the opportunity to have the income tax liability arising post-petition discharged in bankruptcy. In context, the term post-petition includes income generated prior to the date of filing bankruptcy and yet occurring during the tax year of filing. The court reached that conclusion by finding that post-petition sales of farm and ranch property are not “incurred by the estate” under Section 503(b) of the Bankruptcy Code and, therefore, are not collectible from the estate and are not eligible for discharge under the Chapter 12 plan.

History of the problem

The heart of the problem is that Chapter 12 bankruptcy estates are not eligible for separate entity status under the Bankruptcy Tax Act of 1980, which granted separate entity status for individuals filing under Chapter 7 and 11 bankruptcy. Indeed, the 1980 legislation denies separate entity status to other bankruptcy filers, including those filing under Chapter 12 for family farmers and fishermen. Separate entity status is the way individual Chapter 7 and 11 bankruptcy debtors qualify for a “fresh start” from income tax liabilities generated in bankruptcy.

Separate entity status is important to debtors because of the opportunity to avoid income tax liability on post-petition income and even some pre-petition income if the election is made to close the debtor’s tax year as of the beginning of the year of bankruptcy filing which assures that income from the “first short year” (from the beginning of the year until the day before the date of bankruptcy filing) will be treated as a priority claim against the bankruptcy estate and not against the debtor.

In a 1992 case, the court confirmed that income tax liability incurred in a Chapter 12 bankruptcy filing is the responsibility of the debtor. That touched off a major effort to secure comparable treatment for income tax liability for Chapter 12 filers as was available to Chapter 7 and 11 individual filers.

The 2005 Act

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 contained a provision allowing a Chapter 12 debtor to treat “claims owed to a governmental unit,”

* Charles F. Curtiss Distinguished Professor in Agriculture and Emeritus Professor of Economics, Iowa State University; member of the Iowa Bar.
** Day, Rettig Peiffer, P.C., Cedar Rapids, Iowa
including income tax on the gain or recapture income, as a result of “. . . the 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.10

Subsequent litigation

The language in the 2005 Act touched off litigation that led to a decision by the Eighth Circuit Court of Appeals11 that favored the debtor on three important issues — (1) Chapter 12 debtor could treat post-petition taxes imposed on the debtor’s income earned during the Chapter 12 proceeding as an administrative expense; (2) sales of ordinary income property were eligible for the special treatment in the 2005 Act and (3) the “marginal” method was the correct way to allocate taxes between the priority and non-priority claims under Chapter 12.12 The holdings of Knudson were followed by In re Ficken,13 It is not completely clear at the moment what the Hall decision means for Knudson.

In the case of United States v. Hall, et ux.,14 the Ninth Circuit Court of Appeals held that the 2005 enactment of § 1222(a)(2)(A) did not apply for post-petition taxes because there was no separate taxable entity created by the filing of the Chapter 12 petition.15 The Supreme Court agreed to hear the Hall case on June 13, 2011. Argument was held on November 29, 2011 and the case was decided on May 14, 2012. Hall, et ux. v. United States

The United States Supreme Court, in its strict-constructionist decision in Hall, et ux. v. United States16 held that a Chapter 12 bankruptcy estate is not a separate entity for federal income tax purposes and, therefore, the federal income tax liability incurred from post-petition sales is not “incurred by the estate” within the meaning of Section 503(b) of the Bankruptcy Code. Consequently, the tax is neither collectible from the estate nor dischargeable under the Chapter 12 plan.

The majority opinion, responding to Congressional statements on the provision from the 2005 Act, quoted from another case, Milner v. Department of the Navy,17 in which the court cautioned against “allowing ambiguous legislative history to muddy clear statutory language.” The legislative history to which the majority referred was the statement of Senator Grassley and other bipartisan Senators that accompanied the introduction of S. 260 “Safety 2000” on January 19, 1999 as there was no statement in the Congressional Record accompanying § 1003 of BAPCPA, § 1222(a)(2)(A). From a fair reading of the record, one could easily conclude that the legislative history was not “ambiguous” and the legislative language was a respectful distance from being “clear statutory language.” The majority opinion was delivered by Justice Sotomayor with Justices Roberts, Scalia, Thomas and Alito joining in the opinion.

The dissent, written by Justice Breyer, joined by Justices Kennedy, Ginsburg and Kagan, makes the pithy observation that the majority’s opinion “reduces Congress’ Amendment to rubble” and concludes with the statement that it is important “. . . that courts interpreting statutes make significant efforts to allow the provisions of congressional statutes to function in the ways that the elected branch of Government likely intended and for which it can be held democratically accountable.”18

The practical impact of this decision is that the tax will be collectible from the debtor after the entry of the discharge in the Chapter 12 case. This is the worst possible outcome for the debtor as the post-petition sale of farm assets can occur with the secured creditor receiving the proceeds, then, the unsecured creditors receiving any remaining proceeds, with the debtor being required to pay the income taxes on the gain after entry of the discharge.19 Thus, the ball is back in the Congressional court. U.S. Senator Charles Grassley has stated that he will introduce legislation to clarify the law to protect farmers from full tax liability.

ENDNOTES


2 Knudson v. Internal Revenue Service, 581 F.3d 696 (8th Cir. 2009); United States v. Hall, 617 F.3d 1161 (9th Cir. 2010).


5 I.R.C. § 1398(a).

6 See note 1 supra.

7 See In re Mirman, 89-1 U.S. Tax Cas. (CCH) ¶ 9297 (E.D. Va. 1989) (debtors individually liable for income taxes for year involuntary bankruptcy filed against them where debtors did not elect to end taxable year as of day before bankruptcy filing); In re Prativedi, 281 B.R. 816 (Bankr. W.D. N.Y. 2002) (taxes for year of bankruptcy filing were post-petition debt where debtors did not elect to bifurcate tax year of bankruptcy filing).

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


11 Knudson v. Internal Revenue Service, 581 F.3d 696 (8th Cir. 2009).


13 430 B.R. 663 (10th Cir. BAP 2010).

14 617 F.3d 1161 (9th Cir. 2010).


