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Major developments in Chapter 12 bankruptcy*

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In the most far-reaching revision of bankruptcy law since 1978, Congress has passed and the President is expected to sign legislation making major changes in bankruptcy law. With respect to agriculture, the changes are principally in two areas –

(1) amendments to the eligibility requirements for Chapter 12 filing and
(2) modification of the income tax treatment of gains on property liquidated in connection with a Chapter 12 bankruptcy reorganization. A third major area of importance is that the homestead exemption is limited to $125,000 if the debtor purchased the residence less than three years and four months (defined as 1215 days) before filing. There are exceptions for-

(1) the residence of a “family farmer” and
(2) any amount rolled over from another residence acquired by the debtor before the 1215 day period provided the prior and current residences are located in the same state.

Eligibility requirements

Perhaps the most significant features of the new legislation are that it makes Chapter 12 bankruptcy permanent and extends the provisions of Chapter 12 to a “family fisherman” although with different requirements imposed for eligibility. The definition of the term “family farmer” is changed to allow an individual or an individual and spouse engaged in a farming operation to have aggregate debts not to exceed $3,237,000 (up from $1,500,000 under prior law) with not less than 50 percent of the aggregate, noncontingent, liquidated debts (excluding the debt from a principal residence) arising out of a farming operation (down from 80 percent under prior law). Moreover, the requirement that more than 50 percent of gross income must be received from a farming operation the taxable year preceding filing has been relaxed to allow the 50 percent test to be met, in the alternative, during the second and third tax years preceding filing. Thus, a Chapter 12 filer must have more than 50 percent of its gross income from farming in either the tax year prior to filing or in both the second and third tax years prior to filing the Chapter 12 petition.

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The dollar requirements are also to be adjusted for inflation at three year intervals.

The requirements imposed on a “family fisherman” remain the same as were imposed on “family farmers” before the 2005 amendments. That is, aggregate debts cannot exceed $1,500,000, not less than 80 percent of the aggregate noncontingent, liquidated debt must arise out of a commercial fishing operation and the 50 percent gross income test must be met during the taxable year preceding filing.

The 2005 Act does not impose the 50 percent gross income test on otherwise eligible partnerships and corporations for family farmers. That was believed to have been an omission in the 1986 legislation enacting Chapter 12 but it was not changed in the 2005 amendments.

Post-petition taxes
The legislation contains a new provision of immense potential importance to Chapter 12 filers. That provision allows a Chapter 12 debtor to treat claims arising out of “claims owed to a governmental unit” as a result of “sale, transfer, exchange, or other disposition of any farm asset used in the debtor's farming operation” to be treated as an unsecured claim that is not entitled to priority under Section 507(a) of the Bankruptcy Code, provided the debtor receives a discharge. Note that nothing in the legislation specifies when the property can be disposed of to be eligible for unsecured claim status. Of course, the taxing agencies must receive at least as large an amount as they would have received had the claim been a pre-petition unsecured claim. The key point is that, under prior law, taxes were a priority claim and had to be paid in full. Even though the priority tax claims could be paid in full in deferred payments under prior law, in many instances the debtor did not have sufficient funds to allow payment of the priority tax claims in full even in deferred payments.

This amendment addresses a major problem faced by many family farmers filing under Chapter 12 where the sale of assets to make the operation economically viable triggered gain which, as a priority claim, had to be paid.

Operationally, if a Chapter 12 bankruptcy filer has liquidated assets used in the farming operation within the tax year of filing or liquidates assets used in the farming operation after Chapter 12 filing as part of the Chapter 12 plan, and gain or depreciation recapture income or both are triggered, the plan should provide that there will be no payments to unsecured creditors until the amount of the tax owed to governmental bodies for the sale of assets used in the farming operation is ascertained. The tax claims are then added to the pre-petition unsecured claims to determine the percentage distribution to be made to the holders of pre-petition unsecured claims as well as the claims of the governmental units that are being treated as unsecured creditors not entitled to priority. With that approach, all claims that are deemed to be unsecured claims would be treated equitably.

Arguably, if a debtor determined post-confirmation that, to insure financial and economic viability, assets used in the farming operation must be liquidated, the Chapter 12 plan could be modified to allow the sale of assets so long as the modified plan made provision to make payments to the taxing bodies in an amount that would equal or exceed what would have been received had it been a pre-petition unsecured claim. Upon entry of the Chapter 12 discharge, the claim of the governmental body for taxes on the sale of assets used in the farming business would also be discharged. If the debtor does not receive a Chapter 12 discharge, the taxing bodies are free to pursue the debtor as if no bankruptcy had been filed, assessing and collecting the tax and all penalties and interest allowed by law.

The 2005 Act also specifies that a Chapter 12 plan may provide for less than full payment of all amounts owed for a claim entitled to priority under 11 U.S.C. § 507(a)(1)(B) (a higher priority classification for domestic support obligations continued on page 3
Risk management: What does it really mean?
by Kelvin Leibold, ISU Extension Area Farm Management, kleibold@iastate.edu

A lot of discussion is given to the topic of “Risk Management” but it is usually not well defined. “Risk Management” in agriculture is often thought to encompass five general areas. These areas include Production Risk, Marketing Risk, Financial Risk, Legal Risk, and Human Risk. As we head towards the end of another production cycle and the start of a new, it is prudent that every business review the potential impact of these different risks and what strategies are being used to manage them. Risks are rarely eliminated; the exposure to the risks may just be shifted to another party.

Production risk
The area of risk that most businesses are familiar with is production risk. The government has done a lot to provide tools to manage yield risk through the subsidization of crop insurance. Production risk includes many other areas such as land base and rental rates. A question you may have to answer is: how will you deal with landlords that die or increasingly higher rental rates? Knowing the answer now can help manage the risk later. Maintaining a land base at a reasonable cost is becoming a greater challenge as more land is owned by out of state landlords.

The 2005 Act also adds a new provision requiring an individual Chapter 12 debtor to be current on post-petition domestic support obligations as a condition of confirmation of a plan.

Effective dates
Except as otherwise provided, the amendments made by the Act are effective 180 days after enactment, the date of the President’s signature. However, the provision making Chapter 12 bankruptcy a permanent part of the Bankruptcy Code was effective July 1, 2005.

The bill also specifies that, except as otherwise provided, the amendments do not apply to cases commenced under Title 11, United States Code (the bankruptcy provisions) before the effective date of the Act. The amendments made by Sections 308, 322 and 330 apply with respect to cases commenced under Title 11 on or after the date of enactment of the Act.

The Chapter 12 tax provisions (Section 1003 of the Act) are effective upon enactment, as is the homestead exemption provision.

Conclusion
The 2005 amendments make highly important changes to Chapter 12 bankruptcy. The changes involving the possible conversion of taxes on the sale of assets used in the farming operation to the status of pre-petition unsecured claims are particularly notable.