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Bankruptcy Filing After Special Use Valuation Election

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

Rarely is bankruptcy filing contemplated when a special use valuation election of farmland is filed. However, financial adversity can overtake a qualified heir or heirs who are responsible for paying the recapture tax either because of reduced farm or ranch income from production or a major catastrophe which results in a filing in bankruptcy. Several possible issues may arise, including the effect of bankruptcy on personal liability for the tax benefits from the special use valuation filing.

The effects of bankruptcy filing if special use land is not transferred from the bankruptcy estate during bankruptcy

The Internal Revenue Code is clear as to the effects of bankruptcy filing for individuals who are Chapter 7 and 11 filers. In general, the transfer of assets to the bankruptcy estate is not treated as a disposition for purposes of any provision of this title. The term “this title” refers to Title 26 of the United States Code which includes federal income tax, federal estate tax, federal generation skipping transfer tax and federal gift tax. The bankruptcy estate is treated as the debtor would have been treated. Thus, it is clear that the mere filing of bankruptcy does not trigger recapture of the tax benefits from the special use valuation election.

Likewise, it is clear that, if the farmland subject to the special use valuation election is retained by the bankruptcy estate in a Chapter 7 or 11 filing by an individual, later transfer of the assets from the bankruptcy estate to the debtor on termination of the bankruptcy estate is not treated as a disposition for purposes of any provision of this title and the debtor is treated as if the bankruptcy estate would have been treated and there should be no recapture.

Chapter 12 bankruptcy filers are not eligible for a separate tax entity which is available for Chapter 7 and 11 filers as individuals. However, a 2005 amendment allows a Chapter 12 debtor to treat amounts 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 obtains a discharge. That provision has been upheld by the Eighth Circuit Court of Appeals.

Effects of transfer of special use land during bankruptcy

If real property under a special use valuation election is transferred by the bankruptcy estate during bankruptcy...

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trustee to an eligible transferee, such as a member of the debtor’s family,14 there should be no recapture of the tax benefits from the special use valuation election.15 However, if the property is transferred to an individual or entity who is not a member of the qualified heir’s family, and thus is not an eligible transferee for purposes of special use valuation recapture,20 recapture occurs.

If the recapture tax, which is an “additional estate tax,”21 is triggered by the bankruptcy estate, the recapture amount would presumably be paid by the bankruptcy estate if the bankruptcy estate has sufficient funds available to pay the recapture tax. The additional estate tax appears to be an “excise tax” as a tax levied upon the transfer of a person’s property at death and would be paid as an administrative expense of the bankruptcy estate.22 For Chapter 12 filers, with no separate tax entity, the tax would likely not be an administrative expense unless the Eighth Circuit Court of Appeals case, Knudsen v. Internal Revenue Service23 is followed.

Because the special use valuation recapture tax is secured by a lien, payment of the tax is subject to a special priority payment system. Because the lien is not avoidable by the bankruptcy trustee or debtor in possession, the bankruptcy estate special use valuation property which is subject to the tax lien is distributed first to satisfy any other allowed secured claims against the property and all unsecured claims with a higher priority than pre-petition tax claims.24 The tax lien is not avoidable because the lien arose prior to, and not because of, the filing for bankruptcy.25 Any special use valuation recapture tax that remains unpaid would be an unsecured claim, and if the bankruptcy estate does not have sufficient assets to pay the remaining tax, the question is whether the debtor remains liable for the tax if it is not dischargeable.

What about the debtor’s personal liability for the recapture tax?

A qualified heir, who is a debtor in bankruptcy has personal liability for federal estate tax recaptured as a result of disposal of the property outside of the qualified heir’s family within 10-years after the decedent’s death (15-years for deaths before 1982).26 As an excise tax, if personal liability was incurred prior to three years before filing for bankruptcy, the amount of the claim for recaptured federal estate tax should be dischargeable in bankruptcy. For Chapter 12 filers, the Eighth Circuit case of Knudsen v. Internal Revenue Service27 could provide relief even if three years had not elapsed from the time of disposition provided all of the other requirements for Chapter 12 bankruptcy have been met.

The key issue is whether the debtor’s contingent liability to pay the recapture tax survives the transfer of property to the bankruptcy estate. If it does, the liability is arguably not dischargeable in bankruptcy because the claim did not arise prior to the filing of bankruptcy.

To date, there is no definitive authority on whether the contingent liability of the debtor for payment of the recapture tax survives bankruptcy and subjects the debtor to liability for the recapture tax in question.

ENDNOTES


2 See 13 Harl, Agricultural Law Ch. 120 (2011).

3 I.R.C. § 2032A(c).

4 I.R.C. § 1398(a).

5 I.R.C. § 1398(f)(1).


7 I.R.C. §§ 1-1563.


9 I.R.C. §§ 2601-2664.

10 I.R.C. §§ 2501-2524.


12 5 Harl, Agricultural Law § 43.03[2][g][i][C] (2011).

13 I.R.C. § 1398(f)(2).

14 See 5 Harl, Agricultural Law § 43.03[2][g][i][C][I].

15 I.R.C. § 1398.


17 Knudsen v. Internal Revenue Service, 581 F.3d 696 (8th Cir. 2009). But see United States v. Hall, 617 F.3d 1161 (9th Cir. 2010), on appeal to the U.S. Supreme Court.

18 I.R.C. § 2032A(c)(1)(A).

19 See 5 Harl, Agricultural Law § 43.03[2][g][i][C][I] (2011).


21 I.R.C. § 2032A(c)(1)(B).


23 581 F.3d 696 (8th Cir. 2009).


26 I.R.C. § 2032A(c)(1).

27 581 F.3d 696 (8th Cir. 2009).